The Ethics of Money:

The Place of Values in Contemporary Banking

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This thesis contains no material which has been accepted for a degree or diploma by the University or any other institution, except by way of background information and duly acknowledged in the thesis, and to the best of my knowledge and belief, no material previously published or written by another person except where due acknowledgement is made in the text of the thesis.

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Contents

Abstract

Banks have a central role and importance in all commerce and hence in all societies. This thesis investigates the ethical basis of banking practice with the aim of developing an account of the virtues appropriate to bankers and banking. One central issue concerns a conflict between the interests of banks and their customers, and how this conflict plays out in relation to the lending policies and fee structure of banks. Such lending policies can have a significant effect on banks, their customers and a range of stakeholders. This research project investigated empirical evidence through qualitative interviews with senior bankers in two locations, Australia and Hong Kong, to elicit their thoughts on banking areas that involve customer interaction, namely, deposit-taking, credit cards, home mortgage loans, corporate finance, and foreign exchange. The institutions selected hold a substantial segment of banking business in their respective countries and are thus representative of bankers' perspectives. The dissertation also entailed a case study of the causes and consequences of the American sub-prime crisis that was precipitated by the financial sector. The interviews revealed an assertion of good ethical conduct based on adherence to peer-determined codes of conduct and compliance with regulations. There was also a common predisposition to claims of corporate social responsibility and reputation preservation but these have tended to mask the powerful underlying sales thrust. A key finding of the study points to a lapse in ethical values in banks due to excessive reliance on self-interest. Although self-interest is not in itself wrong, there has been a lack of moderation vis-à-vis the interests of less powerful customers. A related finding is a prevailing resistance to regulation that is necessary to curtail selfish and

irresponsible behaviour by banks. The interview subjects prefer industry self-regulation to government supervision. However, the banks in Australia and Hong Kong, which have been subjected to tighter regulation, have survived the global financial crisis better than their American counterparts despite complaints about the severity of their regulatory climate. There is a strong case to ascribe ethical failure to American practices that triggered the sub-prime calamities, which have devastated homeowners and the global economy. American banks and regulators both operated on the erroneous supposition that the quest after extreme profits would be restrained by free market forces. The conclusions allude to virtues that are necessary for banks to espouse moral conduct. These virtues can be embedded through leadership and cultural change.

Part A. Approaching Banking from a Philosophical Perspective

CHAPTER 1. GLOBAL CREDIT CRISIS

A. Apocalypse

The credit crunch that had first manifested itself in August 2007 was accelerating briskly during the summer months in the northern hemisphere, though much of the population outside mainstream finance in America and England was oblivious to this ominous tidal event. By September 2007 the U.S. Federal Reserve Bank had started to slash interest rates so dramatically that economists expressed concern that such action might spark off a downturn. The American central bank had taken this action to avert some of the harmful consequences on the economy,[1] but even then it could not stop the tidal wave. As the Economist reported at that time:

> But trouble may be coming anyway. The housing market's malaise is deepening all the while. This week's symptoms were a 12-year low in housing starts and a doubling of foreclosures in a year. No wonder house builders are at their gloomiest since the 1991 recession.[2]

[1] Editor, "Will the Credit Crisis Trigger a Downturn?," *The Economist*, 22 September 2007, www.economist.com (accessed 29 September 2007).
[2] Ibid.

Despite the rapidly spreading distress, bankers still had a sanguine outlook in November 2007, proclaiming circumstances would be different this time.[3] Bankers had been responsible for the circumstances that instigated the collapse of credit but they failed to appreciate the full ramifications. Several top bankers would soon be fired and leading financial institutions would collapse, eventually requiring government rescue. As the analyses in Chapters 6 and 7 will highlight, the roots of the troubles lay in the flawed ethos of sub-prime loans, which were characterised by irresponsible lending. Most of these loans subsequently became delinquent, and by July of 2007 the affected banks were required by regulations and accounting convention to set aside commensurate loan loss provisions. These substantially impaired their equity position and compelled them to raise funds in the capital and money markets. As in any panic-driven rush, many would be crushed along the way while only a few banks would survive the credit squeeze.

Central banks around the world responded to this credit crisis with unprecedented interest rate cuts in order to restore liquidity in the financial markets, but the problems were the collapse of trust among banks in each other (as will be probed in Chapter 7) and the defensive reaction of banks to discontinue lending to most of their customers. Even after central banks continued to drop interest rates, banks would either not resume lending or would do so at higher interest margins to preserve profits. The cycle of trust that is so essential to banking had been ruptured.

What were the immediate and continuing repercussions? Firstly, as later chapters will show, millions of homeowners lost their homes and incurred substantial financial costs. Secondly, countless companies that could not get hold of economically viable financing were forced to cut production and employment. Many

[3] "Loss Leaders," *The Economist*, 3 November 2007, www.economist.com (accessed 10 November 2007).

major industries would suffer economic hardship, for example, automobiles, airlines, heavy equipment, consumer goods, department stores, and restaurants, among others.

B. Paradise Lost

Despite attempts to find other scapegoats, most economists agree that the blame for the global financial crisis lies with the banks.

> Banking is the industry that failed. Banks are meant to allocate capital to businesses and consumers efficiently; instead, they ladled credit to anyone who wanted it. Banks are supposed to make money by skilfully managing the risk of transforming short-term debt into long-term loans; instead they were undone by it. They are supposed to expedite the flow of credit through economies; instead they ended up blocking it.[4]

Having broken down as an industry, America's financial-services companies were the earliest ones to suffer, slashing nearly half a million positions since the heights of December 2006, more than half of them in the seven months prior to mid-May 2009. Many jobs were permanently eliminated.[5]

The financial disaster started with the asset bubbles created through excessive and irresponsible lending that inevitably had to burst. But this was a *crisis not just of money but also of confidence* because the problems had been greatly magnified through certain unique aspects of modern finance, which we will further examine in Chapter 7. These included the innovation of synthetic derivatives to create exposure to risk without actually having to own the underlying assets; the application of fair-value accounting, which compelled financial institutions to constantly evaluate assets

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[4] "Special Report: Rebuilding the Banks," *The Economist*, 14 May 2009, www.economist.com (accessed 20 May 2009).

[5] Ibid.

on the basis of current market prices that could activate signals to dispose of investments, further pushing down prices, until the process became a vicious circle. The principal accelerant was excessive leverage.[6]

The amplifiers noted above could have been kept under control if banks had exercised better governance under sound ethical principles or if regulators had acted judiciously to prevent negligent bank practices. Alan Blinder, a professor of economics at Princeton and former vice chairman of the Federal Reserve, raised the same criticism and especially found fault with government regulators for allowing sub-prime loans to flourish and for its failure to contain home foreclosures.[7]This crisis is acutely severe because of the unique characteristics of banks. A Special Report on International Banking explains why banks are special:

> The first reason...is the inherent fragility of their business model...Even the strongest bank cannot survive a severe loss of confidence, because the money it owes can usually be called in more quickly than the money it is owed. The second reason banks are special is that they do lots of business with each other. The third and most important reason is the role that the banks play as the wheel-greasers of the economy, allocating and underwriting flows of credit to allow capital to be used as productively as possible. That process has now gone into reverse.[8]

After the crisis erupted in the banking sphere, it gradually spread to non-financial businesses with the onslaught of recession at the end of 2007. From that time till May 2009 America had shed 5 million jobs. It was estimated that more than 15% of the workers were either jobless or underemployed. The market value of listed

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[6] "Paradise Lost: A Special Report on International Banking," *The Economist*, 17 May 2008, www.economist.com (accessed 24 May 2008).
[7] Alan S. Blinder, "Six Errors on the Path to the Financial Crisis," *The New York Times*, 25 January 2009, www.nytimes.com (accessed 27 January 2009).
[8] "Paradise Lost: A Special Report on International Banking."

shares in American companies tumbled 57% from its high point in October 2007 to a low in March 2009, with some recovery thereafter.[9]

Since the credit squeeze had progressed to a global recession, the industry slowdown was felt in all countries. On 26 January 2009 major multinational companies that included, among others, Caterpillar, ING, Pfizer and Sprint Nextel announced several thousands of job cuts each; the International Labour Organisation issued a gloomy forecast of an upsurge in the global jobless rate to 7.1% this year or 230 million people, which is a significant growth from 179 million in 2007.[10] Such large-scale unemployment is a cruel penalty on innocent victims.

In the spring of 2009 both General Motors (GM) and Chrysler, which had once been respectively the largest and the third biggest carmakers in America, were forced into bankruptcy proceedings because they were slowly haemorrhaging due to the drastic collapse of their sales. Though the fundamental reason behind the failure of both firms was inefficiency and overproduction, the immediate factors behind their demise were the higher cost of finance[11], which was extremely difficult to obtain, and the sudden reduction of the take-home pay of American consumers. Many individuals had lost their jobs while others were constrained to embrace a more frugal lifestyle that meant either not regularly changing cars or buying cheaper and fuel-efficient imports. The American car manufacturers had reacted defensively to the influx of better and more efficient Japanese cars in the 1970s by lobbying for government protection instead of responding in kind; in addition, their ill-conceived

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[9] "Special Report: Surviving the Slump," *The Economist*, 28 May 2009, www.economist.com (accessed 1 June 2009).

[10] "Swinging the Axe," *The Economist*, 29 January 2009, www.economist.com (accessed 31 January 2009).

[11] "At the Gates of Hell," *The Economist*, 24 November 2007, www.economist.com (accessed 29 November 2007). "It was disclosed that bankers of Cerberus, the private equity investor that had bought control of Chrysler, abandoned efforts to sell US$4 billion of debt it had incurred for the purchase. In 2006 Cerberus had also bought 51% of GMAC (the financing arm of General Motors) for US$14 billion but this had lost US$1.6 billion just for the third quarter of 2007."

agreement on benefits with the unions saddled them with a heavy cost structure. GM's bankruptcy will result in the loss of 14 factories, 29,000 workers and 2,400 dealers in America;[12] it will also involve the sale of the European operations.

C. Banks and Household Debt

Household savings have traditionally provided a strong impetus to economic growth in many countries, but conditions have changed in recent years. In the American situation personal indebtedness rose steadily, from less than 80% of disposable income in 1986 to nearly 100% in 2000 and by 2007 it had climbed to 140%.[13] Looking at actual numbers, the financial historian Niall Ferguson noted that by 2007 American consumer debt had soared to a record US$ 2.5 trillion.[14] A study entitled "For a New Thrift: Confronting the Debt Culture" commented that the reckless debt culture trapped individuals in a morass of poverty and destroyed lives. Statistics showed that credit-card debt nearly tripled between 1989 and 2001, increasing from US$ 238 billion to US$ 692 billion; by 2008, it grew to US$ 937 billion.[15] The debt was in the main issued by banks though there were also non-bank financial institutions to blame.

Debt can be a good thing because it enables people to purchase homes, buy goods that contribute to a better quality of life, or embark on business ventures. But

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[12] Editor, "Detroitosaurus Wrecks," *The Economist*, 4 June 2009, www.economist.com (accessed 8 June 2009). It was estimated that, "until an agreement in 2007 with the union, each car in Detroit carried about $1,400 in extra pension and health-care costs compared with the foreign-owned competitors in America."

[13] "When Fortune Frowned: A Special Report on the World Economy," *The Economist*, 18 October 2008, www.economist.com (accessed 25 October 2008).

[14] Niall Ferguson, *The Ascent of Money: A Financial History of the World* (London: Penguin Group, 2008), p. 61.

[15] David Brooks, "The Great Seduction," *The New York Times*, 10 June 2008, www.nytimes.com (accessed 12 June 2008).

consumer credit cuts two ways. It brings convenience and expanded options, but, if its promoters are deceptive, it can encourage reckless behaviour and lead to tragedy, as the sub-prime mortgage foreclosures have excruciatingly demonstrated.[16] The mortgage loan problems will be examined in Chapter 6.

The study cited above stated that the percentage of American families with debt-service obligations in excess of 40% of their income increased to 12.2% in 2004. Delinquencies on household debt also rose during this period. Late fees on credit cards totalled US$ 17.1 billion in 2006.[17]

The credit crisis did not just impact on bank customers; it also affected whole societies. Unwitting municipalities suffered investment losses; suburbs declined in value as property foreclosures proceeded; cities and states faced declining tax revenues due to the misfortunes of their constituents; countries suffered drastic financial straits (Iceland would be virtually bankrupted). The shaping force of money on society is manifest in all activities. And banks as the mediator of money have an enormous impact on human lives in all countries.

D. Judgment on the Banks

Given the great importance of banks and the fears about the consequences of their failure, governments throughout the world have committed to saving the financial system. Many of the institutions that failed were judged too big to fail because there was anxiety that their demise could cause the collapse of the global economy. A massive bank rescue has therefore been launched. In May 2009 it was still highly

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[16] Barbara Dafoe Whitehead, "A Nation in Debt," *The American Interest* July / August (2008): http://www.the-american-interest.com/article.cfm?piece=458 (accessed 2 November 2008).
[17] Ibid.

uncertain what form and size of support governments would eventually extend to their banks. Nonetheless governments are already heavily involved in banking systems. They are guarantors of far more retail deposits than prior to the crisis. They guarantee new debt issues of banks. Governments have acquired and own preferred shares in many banks, common equity in some and are prepared to infuse capital in others if necessary. Banks that have not sought any government funds still benefit from their reassuring presence. "We all exist at the largesse of the government right now," says a bank boss.[18]

But what caused the banks to fail? The American evidence indicates an ethical failure, which was demonstrated through irresponsible lending, a lack of concern for the plight of borrowers, and a lack of transparency.

The empirical research of this thesis examines the conduct of banks in their day-to-day activities to identify the values and principles underlying their actions. The focus is on those areas of banking directly affecting customers, because that is where banks demonstrate deep-rooted ethical views. The thesis also presents a case study of the American sub-prime mortgage loan crisis, in which its causes and consequences are analysed in order to draw some lessons for the future. Moral deficiencies are revealed as the grounds that instigated the crisis.

[18] "Special Report: Rebuilding the Banks."

CHAPTER 2. VIEWS OF BANKING ETHICS

A. Development of Modern Banking

Much of the current financial structure can be traced to three innovations in the 17th century. The first of these was the establishment of a system of bank transfers that has survived to this day in the form of cheque issuance and inter-bank transfers. The second was the foundation of fractional reserve banking that enabled banks to lend substantially more than the amount of deposits they carried on their books. The third was the creation of the Bank of England as the official issuer of bank notes, which were initially backed by gold bullion, and the keeper of bank reserves. The modus operandi of banking was twofold: on the one hand, a bank had to be able to guarantee its depositors that they could withdraw their money whenever they wanted; on the other hand, the same bank had to lend the funds out so it could generate income in order to be able to pay interest to encourage the depositors to place their funds. The three innovations were the original measures that made possible the institution of modern banking.[1] Essentially reserve banking means that, if the reserve requirement is, for example, 10%, a bank can lend out 90% of say \$100, that is \$90, to another person who may deposit that amount at another bank, which in turn can lend out \$81 to a third person, and this goes on to the next bank and borrower. The initial deposit of \$100 has created loans of \$171 and is capable of creating even further loans, so this is called the 'multiplier effect' in money creation, and this allows banks to greatly expand lending.

[1] Ferguson, *The Ascent of Money*, p. 47.

The institution of reserve banking did not completely eliminate the possibility that most depositors in any given bank might want to withdraw their funds at the same time and, if the affected bank had insufficient cash on hand because it had loaned out most of its deposits or if the bank had uncollectible loans, then the bank suffered a bank run.[2] The introduction of deposit insurance in certain countries has protected depositors in affected banks in those countries and given peace of mind to others. Banking regulators have sought to prevent such eventualities through close supervision to ensure a stable banking system and adherence of banks to prudent practices.

B. Necessity for Banks in Contemporary Period

It is crucial to have a robust and sound banking structure because of the central role of banks in every society. Economic growth has witnessed the constant flow of money through banks, and a breakdown of the financial system as witnessed in the contemporary period 2007 – 2009 creates havoc throughout society because everyone is reliant on banks.

Workers in many service and manufacturing entities receive their salaries or wages from their employers through direct credit transfers to their respective bank accounts. While there are some instances of cash payment, compensation for employment is normally effected through banks. At a minimum, employers would probably maintain accounts at banks out of which they pay salaries, rental and

[2] Most bank runs are instigated by rumours of bank insolvency, which may not always be grounded on true circumstances, but in a panic situation most people do not usually bother to ascertain the facts.

utilities, as well as taxes. Employees would likely have at least savings accounts and possibly current accounts in order to facilitate their own regular payments to others.

More importantly, people in most countries have also relied on banks for issuance of credit cards, housing mortgage loans to acquire homes, and personal loans to purchase consumer durables such as motorcars, boats, and household appliances.[3] Once individuals have assumed a debtor relationship with banks, as a rule they are obliged to establish deposit accounts with the same banks.

Companies, which may range from sole proprietorships to partnerships to corporations, avail of bank services to ensure they earn competitive interest rates on deposits and also receive financing to meet standard operating requirements and further needs such as trade finance to support imports of raw materials and exports of finished goods as well as foreign exchange transactions to shield them from the potential losses of unfavourable currency fluctuation. The large companies are especially reliant on corporate finance to support new capital expenditures.

It is therefore indisputable that all members of society are dependent on banks, which are expected to serve the function of intermediation. It is equally important to stress that banks require customers, if they are to earn any income and attain profits, so the question is how ethically banks deliver their services. The argument is that banks are indispensable members of their respective communities and therefore have moral obligations towards their constituents and customers.

The question now turns to the ethical framework that guides policies and procedures in banks. What are the values and motivation of bankers that shape their

[3] This is certainly the case in the two countries selected for the empirical research, Australia, and Hong Kong, and also in America, which is the location of the case study. In contrast, many people in Germany are reluctant to use credit cards or obtain mortgage loans to buy homes; they prefer to rent even for extended periods of time.

actions? In the effort to identify these values it is beneficial to review some philosophical views that may be relevant to the analysis.

Since the dawn of civilisation numerous moral thinkers, who will be discussed in subsequent sections, have proffered ethical theories pertaining to money and banking customs. Some of these are deontological in prescribing duty or forbidding certain acts; one enduring concept lasting several centuries argued against charging interest on money. Another contentious debate was directed at the morality of the profit motive, which was again raised during the current global financial crisis. One ethical approach that continues to hold sway is utilitarianism, which seeks to evaluate the morality of an act according to its contribution to overall utility, defined as pleasure or happiness of people. On the other hand, the Kantian categorical imperative stresses the use of reason to discern moral obligations. Other theories, which are especially relevant in the current period, stem from the idea of the social contract and focus on justice and what we owe to each other. The evaluation of the empirical research on banks and the case study on the sub-prime crisis will seek out the pertinent ethical concepts applied by the respective actors. Unlike theorists, banks might not subscribe to a single ethical approach but instead rely on a plurality of ethical norms.

The public image of banking is usually manifest in the statements of corporate principles that individual banks release. These normally stem out of perceptions of duty, which could be attempts of legal compliance but there might also be motivational factors arising out of inherent moral values. The ensuing review commences with a discussion of some earlier ethical concepts that have influenced attitudes towards banking, in particular the issue of usury. Nowadays there is fierce resentment against banks charging excessive interest; long ago, there were religious and philosophical arguments against paying any interest at all. Receiving interest earnings is, of course, the fundamental method whereby banks earn income, and this is directly related to the subsequent topic of profits.

C. Usury

Banking would not have been possible before the transformation of beliefs about usury. There was a prohibition against usury or the payment of interest in ancient and early medieval times (which was stricter than the current meaning of usury implying excessive interest rates[4]), because it was deemed wrongful to charge any interest at all. There were religious strictures explicitly pronounced in the Old Testament:

> 35 If one of your brethren becomes poor, and falls into poverty among you, then you shall help him, like a stranger or a sojourner, that he may live with you. 36 'Take no usury or interest from him; but fear your God, that your brother may live with you. 37 'You shall not lend him your money for usury, nor lend him your food at a profit.[5]

> 19 You shall not charge interest to your brother -- interest on money or food or anything that is lent out at interest. 20 To a foreigner you may charge interest, but to your brother you shall not charge interest, that the LORD your God may bless you in all to which you set your hand in the land which you are entering to possess.[6]

There were many more references in the Old Testament, which, as the basis of the Mosaic Law, was obligatory for all Jews but the above passage from Leviticus laid the foundation for the proscription against charging interest in the relationships

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[4] Many countries have lending regulations against usurious rates that are sometimes defined as exceeding 48 % p.a.

[5] Leviticus 25:35-37.

[6] Deuteronomy 23:19-20.

between Jews although the second passage from Deuteronomy was interpreted to grant permission to charge interest to non-Jews or Gentiles. One must understand these biblical instructions within the historical context of the newly formed Jewish people who were emerging from a more primitive nomadic subsistence into an agricultural society. Living in a society required standards and laws to govern relationships. The coming of Jesus as portrayed in the New Testament paved the way for the overturn of the Mosaic Law. As two gospel writers wrote relating to interest:

> Wherefore then gavest not thou my money into the bank, that at my coming I might have required mine own with usury?"
> Finally the master said to him "Why then didn't you put my money on deposit, so that when I came back, I could have collected it with interest?[7]
>
> Thou oughtest therefore to have put my money to the exchangers, and then at my coming I should have received mine own with usury.[8]

Although the New Testament passages cited above allude to a favourable reception towards payment of interest, resistance to the practice continued and the First Council of Nicea meeting in the year 325 enacted Canon 17, which prohibited clergy from receiving interest on loans.[9] The ban by the Church on usury or interest would eventually be extended to the laity commencing in the year 750.[10]

The Jews continued the practice of lending money with interest to Gentiles despite the ban by the Christian Church on usury. Therefore the stereotype of the Jewish lender charging Gentiles interest persisted in literature as found in the fictional Shylock of The Merchant of Venice, the drama by Shakespeare.[11]

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[7] Luke 19:23.
[8] Matthew 25:27
[9] Timothy D. Barnes, *Constantine and Eusebius* (Cambridge, MA: Harvard UP, 1981), p. 536.
[10] John T. Noonan, *The Scholastic Analysis of Usury* (Cambridge, MA: Harvard UP, 1957), p. 11.
[11] Ferguson, *The Ascent of Money*, p. 33-35.

While there were religious arguments against charging interest on money, there was forceful long-lasting opposition emanating from the Greek philosopher Aristotle, who declared in The Politics:

> The trade of the petty usurer is hated with most reason: it makes a profit from currency itself, instead of making it from the process which currency was meant to serve. Currency came into existence merely as a means of exchange; usury tries to make it increase. This is the reason why it got its name; for as the offspring resembles its parent, so the interest bred by money is like the principal which breeds it, and it may be called 'currency the son of currency.' Hence we can understand why, of all modes of acquisition, usury is the most unnatural.[12]

This is the argument of the sterility of money that would be espoused during the Middle Ages by Aquinas, the theologian and advocate of Aristotelian philosophy. According to the philosopher Adrian Walsh this is a rare example of a joke from Aristotle.[13] The explanation comes from the Greek word *tokos,* which signifies both token or currency and offspring. Therefore, as Walsh explicates, Aristotle's remarks about money being unable to produce offspring and therefore an unnatural (and immoral) activity, may be regarded as a play on the dual meaning of the original Greek word. The metaphysics of Aristotle revolved around the distinction between the natural and the unnatural (amongst other things), so it was logical in The Politics for him to describe money and interest thereon in naturalistic terms. Due to the stature of Aquinas as a Church Father and the impact of Aristotle's thinking, this objection to usury continued for centuries. There were supplementary opinions for opposing usury, but this doctrine was eventually abandoned.

The key figure in dismissing the objection against charging interest on money was Calvin, a theologian who contended in 1545 that it was not contrary to religious

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[12] Aristotle, *The Politics*, trans. Ernest Barker (Oxford: Oxford UP, 1995), p. 30.
[13] Adrian Walsh and Tony Lynch, *The Morality of Money: An Exploration in Analytic Philosophy* (Hampshire: Palgrave Macmillan, 2008), p. 95.

teaching or unlawful to receive payment for the use of money and that therefore capital was productive. However Calvin elaborated that there were instances where demanding interest would be sinful, such as the situation of the poor suffering from disasters or charging excessive interest.[14] It is clear that condemnation of exorbitant rates has long been part of religious and philosophical tradition.

While the practice of interest payment is generally accepted in modern times, it is still prohibited in fundamentalist Islamic societies and is treated instead as a rental or hire purchase transaction.[15] However, the apprehension in non-Islamic societies is about the level of interest rates that have sometimes been described as exploitative; Walsh maintains that, even if interest is acceptable, moral considerations must prevail in order to avoid taking advantage of helpless borrowers.[16] This dissertation will examine loan situations approaching usury in the current environment when the case study discusses the sub-prime crisis and predatory lending in chapter 6.

D. Profit Motive

If one accepts that earning interest on money is legitimate and since interest is the primary income and cost of a bank, then the topic of the profit motive becomes an important moral issue. There have been widely differing philosophical stances on this matter that date back to the ancient Greeks and persist to the present time. The principal disapproval of the pursuit of the profit motive comes from those who equate

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[14] Ibid., p. 102.
[15] In such cases the Islamic financial institution does not pay interest on deposits but rather a share of profits; in housing loans the institution buys the property in its own name and the individuals pay regular rental for a pre-agreed duration at the end of which the titles are transferred to the individuals.
[16] Walsh and Lynch, *The Morality of Money*, pp. 112-13.

this with selfishness. However Antony Flew, a philosopher, says this is wrong because self-interest is not identical with selfishness. As an illustration he points out that eating one's meals regularly is in one's self-interest but is not selfish. However, taking another person's dinner in addition to one's own is selfish. Although "selfish actions are perhaps always interested, only some interested actions are also selfish."[17]

According to Flew the long-standing antagonism towards the profit motive is due to three fallacies that stem from Aristotle, one of which is his objection to 'usury' as discussed earlier. Another is the view of trade as exploitation in the sense of it being a zero-sum game with one party always a winner and the other a loser. The error here is in failing to recognise the essential element of reciprocity in trade. Finally there is the distinction made between obtaining goods for one's own use as opposed to a desire for financial earnings.[18] The argument is described as faulty because one would not make a profit if nobody wants what one is selling and, if they are buying, it must mean that one is satisfying a need. This is the underlying basic assumption behind a market-based economy versus a centrally planned regime. However, when the inquiry shifts to the sub-prime crisis in Chapters 6 and 7, one will take note of the divergence of motives between the sub-prime lenders who wanted to earn huge profits and the borrowers who signed up for the loans that they would eventually be unable to repay.

A moral philosopher and early political economist championed by contemporary free market advocates is Adam Smith, whose 'invisible hand' theory from the Wealth of Nations is cited by economists James Tobin and Frank Hahn as

[17] Antony Flew, "The Profit Motive," *Ethics* 86, no. 4 (1976): p. 314.
[18] Ibid.: pp. 314-19.

"surely the most important contribution of economic thought."[19] The passage most often cited reads as follows:

> It is not from the benevolence of the butcher, the brewer, or the baker, that we expect our dinner, but from their regard to their own self-interest. We address ourselves, not to their humanity, but to their self-love; and never talk to them of our own necessities, but of their advantages. Nobody but a beggar chooses to depend chiefly upon the benevolence of his fellow-citizens.[20]

Commentators have referred to that passage to emphasise that individuals who seek their own self-interest are guided by an 'invisible hand' such that their actions result in the common good. However, in her treatise on Adam Smith's thoughts, the economic historian Emma Rothschild (interestingly, she is a member of the prominent Rothschild banking family of England and is married to the development economist Amartya Sen, a Nobel Prize laureate) puts forward the view that the widely held notion of the 'invisible hand' only arose in the 20th century and Smith himself did not seriously endorse in 1776 what has become the standard current reading as advocacy of laissez-faire. She refers to three divergent occasions when he used the term:[21] firstly, in a mocking tone when he described superstitious people ascribing unusual events to supernatural forces in the History of Astronomy; secondly, in the Theory of Moral Sentiments wherein he wrote that the rich "are led by an invisible hand to make nearly the same distribution of the necessaries of life...and thus without intending it, without knowing it, advance the interest of the society..."[22] Thirdly, she mentions that the reference in the Wealth of Nations should be viewed within the

[19] Emma Rothschild, *Economic Sentiments: Adam Smith, Condorcet, and the Enlightenment*, first paperback edition ed. (Boston: Harvard UP, 2002), p. 116.
[20] Adam Smith, *An Inquiry into the Nature and Causes of the Wealth of Nations* (London: George Routledge & Sons, 1776; reprint, 1893), p. 11.
[21] Rothschild, *Economic Sentiments: Adam Smith, Condorcet, and the Enlightenment*, p. 117.
[22] Adam Smith, *The Theory of Moral Sentiments*, ed. D. D. Raphael and A.L. Macfie, 7 vols., vol. I, The Glasgow Edition of the Works and Correspondence of Adam Smith (London: Oxford UP, 1976), pp. 184-85.

context of that period as Smith's defence of free international trade vis-à-vis government imposition of tariffs and import controls. Rothschild finds Smith protesting against import restrictions and against the supporters of such restrictions, who lobby the legislature. In her reading, Smith finds domestic monopolies favourable for certain industries, but not for the country as a whole. According to Rothschild, Smith believes that, in the absence of restrictions, the merchant would still choose to support domestic industry for his own security and unwittingly promote the interest of the whole society. The merchant is therefore led by an invisible hand to promote an end that was not part of his intention.

This interpretation by Rothschild makes the case that Smith was not proposing that individualistic self-centredness or unrestrained market forces should serve as the recommended norm because these would be constrained by some invisible hand and thus result in the common good. More importantly one must bear in mind that Adam Smith was a moral philosopher who was more concerned about the right actions that men should adopt; he was not a supporter of free market capitalism that some modern economists strongly support.

In the Theory of Moral Sentiments that arguably is his best work and where his views remained constant through various editions, Smith unequivocally affirms (Part III Chapter III) the significance of duty and a person's conscience, when he extols the power of conscience in the inner being that serves as the voice of reason and the judge of our conduct. He ascribes to it a sense of justice that prevents us from acting in ways that can cause unhappiness or harm in others. Through our conscience we realise why it is right to be generous and wrong to be unjust, and we learn to love honour and dignity. Most notably Smith wrote the following words in the Theory of Moral Sentiments:

> One individual must never prefer himself so much even to any other individual, so as to hurt or injure that other, in order to benefit himself, though the benefit to the one should be much greater than the hurt to the other.[23]

From a contemporary philosophical view it is evident that a careful reading of the Theory of Moral Sentiments supports Rothschild's insightful economic historical analysis of Wealth of Nations that Adam Smith was not an advocate of unconstrained free enterprise but rather an objector to government taxation on imports. Moreover it comes across consistently that Smith was staunchly ethical in insisting that rational men should act in such a manner so as to cause no harm to fall on others.

According to Rothschild, the understanding by Smith of the invisible hand might have been developed in three ideas: that human action frequently results in unintended consequences, that there is logic or rationality in events, and that the unintended consequences of individual actions sometimes encourage the interests of communities.[24] This is certainly a credible view, and the next section will examine the notion of consequentialism.

Before moving on to other perspectives, one should note that Smith extolled the virtue of justice in his chapter on duty in Theory of Moral Sentiments:

> There is, however, one virtue of which the general rules determine with the greatest exactness every external action which it requires. This virtue is justice. The rules of justice are accurate in the highest degree, and admit of no exceptions or modifications...[25]

These words came from the same man who wrote about the invisible hand. Yet the modern economic interpretation of the term posits a free market where consumers choose the lowest prices and entrepreneurs opt for the highest prices, where there are

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[23] Ibid., p. 137.
[24] Rothschild, *Economic Sentiments: Adam Smith, Condorcet, and the Enlightenment*, p. 121.
[25] Smith, *The Theory of Moral Sentiments*, p. 137.

no regulations or references to justice, yet the unintentional outcome benefits all parties. To place Smith's thoughts in the context of banking, one would say that it is proper for banks to pursue profits provided that they act justly and do not cause harm to other people. Justice is a central focus in social contract theories that will be explored later.

E. Utilitarianism

Utilitarianism is the ethical theory that was initially formulated by Jeremy Bentham and later developed further by John Stuart Mill; it has gained wide acceptance even till modern times. This is the belief which declares that the foundation of morals is 'utility' or the 'greatest happiness' principle and contends that actions are right to the extent they tend to maximize happiness; wrong if they lead to the reverse of happiness.[26] This theory states that the determination of whether an act is morally right depends on its consequences, thus giving it the name of consequentialism. There are several varying approaches that essentially come under the categories of act consequentialism and rule consequentialism.

Act-consequentialist theories initially indicate some principle for ranking overall situations from best to worst from an objective perspective, and then require the agent in every case to act in such a way as to produce the highest-ranked situation he can produce. All such theories share the same concept of what is right which requires each agent to generate the best possible overall outcome.[27] An act is considered morally right if the sum total produces a greater amount of good after subtracting the bad consequences. What distinguishes this approach is that bad

[26] Stephen Darwall, *Consequentialism*, ed. Stephen Cahn, Blackwell Readings in Philosophy (Malden, Oxford: Blackwell, 2003), p. 33.
[27] Samuel Scheffler, *The Rejection of Consequentialism* (London: Oxford UP, 1982).

results are not excluded but are simply outweighed by the aggregate amount of good consequences. The problems one finds with this approach are, firstly, the question of which standard of morality the agent has chosen and whether it is truly objective and applicable in all instances, and, secondly, the issue of expected versus actual consequences.

Consequentialist tenets serve as justification for most banking products, such as deposit services, electronic payment services, credit cards, and housing loans. The conventional wisdom in banks is that the more of these products they can sell, the happier the customers will be. Nonetheless unforeseen outcomes do occur, and, as the case study of the sub-prime crisis will reveal, there are frequently unexpected consequences of catastrophic proportions.

The other approach, rule consequentialism, chooses the rules that would bring about good consequences. Brandt states the principle in the following manner:

> An act is right if and only if it conforms with that learnable set of rules the recognition of which as morally binding -- roughly at the time of the act — by everyone in the society of the agent, except for the retention by individuals of already formed and decided moral convictions, would maximize intrinsic value.[28]

However, Brandt also commented on the above principle that the identified intrinsic value may not necessarily be just and that, if it is correct, there is still a need to be able to explain to a person the rationale for observing the rule if it clashes with his self-interest. Finally, he considered that the application of the principle, even if it need not be required in every instance for all people, would be useful in looking at difficult situations.[29]

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[28] Darwall, *Consequentialism*, pp. 232-33.
[29] Ibid.

One area, which is aptly named motive utilitarianism, looks at the connection between the morality of motives and the morality of actions.[30] Intentions and actions can separately be ethical or not and, even if they are both ethical, they could also be incompatible. According to Adams, *individualistic motive utilitarianism* stipulates that a person's motivation at any given moment is better, the greater the utility of *his* having it at *that* moment, while *universalistic motive utilitarianism* is the concept that "motives are better, the greater the utility of everybody's having them on all occasions."[31] However, even if one has a good motive that brings utility to another person, there could be circumstances that an act with the motive to bring happiness to another is unethical. To take an example in banking, a young teenager in school may be very happy to receive a credit card in his own name so he can buy desirable consumer items such as the latest recorded music and designer clothes, but, if he has no job or independent source of income other than a regular allowance from his parents, he may be unable to repay his debt, so it is unethical to provide him a credit card for his own account.

It would be a correct observation that utilitarianism is a key guiding principle for banks and their managers, since much of their product advertising highlights attainment of happiness as the principal benefit for customers.

F. Categorical Imperative

While consequentialist theories focus on bringing the greatest amount of utility or happiness to others, they do not tell us why we should be ethical and what our

[30] Ibid., p. 236.
[31] Ibid., p. 248.

obligations are. Kant's important contributions to moral philosophy lay in his argument that through our *a priori* reasoning moral duties present themselves to us as absolute. All human beings have *categorical imperatives* that do not command hypothetically (such as, pay your taxes if you do not want to be penalised), but obligate unconditionally (such as, never tell a lie). Some ethicists emphasize the relevance of this Kantian approach to business ethics.[32] A review of this theory will reveal its applicability. The following is Kant's first principle of the categorical imperative: *"Act only on that maxim through which you can at the same time will that it should become a universal law."*[33] This is distinguished from a *hypothetical imperative* whose content we realise only after we have set an objective or a pre-condition.

But how does a person know if she can will her maxim as a universal law? Kant said the test is whether she can exercise her will without contradiction. She has to be able to will her maxim into the whole world as a universal maxim. Certain actions by their nature are appropriate cases for illustration. Consider, for instance, that an individual has the habit of telling lies and personally believes this is acceptable conduct. But if that if lying were to be established universally nobody would believe anybody at all because they would know or expect that everybody is telling a lie.[34]

Christine Korsgaard, a leading Kantian scholar, uses as an example of the first contradiction a man whose guideline is to give a false undertaking in order to obtain some money that he knows he cannot repay. To see whether this can be willed as a

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[32] Norman E. Bowie, *Business Ethics: A Kantian Perspective* (Malden, MA; Oxford, UK: Blackwell, 1999).
[33] Immanuel Kant, *The Moral Law or Kant's Groundwork of the Metaphysic of Morals*, trans. H. J. Paton (London: Hutchinson, 1948), p. 88.
[34] Ibid., p. 91.

universal law, Korsgaard asks us to picture a world where this is the normal practice for borrowing money - anyone needing money acts this way. It would be difficult to envisage that a man, whose basic principle is to lie in order to be able to borrow money, could insist that his guideline become worldwide practice.[35] If one looks at the reverse situation where banks lend money to individuals even if they know the borrowers will not be able to repay, but do so in order to earn profits from the increased interest earnings, and they try to make this a widespread maxim, then one realises the resulting chaos when borrowers could not, or did not, repay their loans. This is evidently a violation of the universality law, which will be investigated further in the chapter on the sub-prime crisis.

Kant wrote that in "practical philosophy we are not concerned with accepting reasons for what *happens,* but with accepting laws of what *ought to happen,* even if it never does happen – that is, objective practical laws."[36] Korsgaard explicates Kant's thesis by stating that each of us always acts with some objective in mind. These may be positive ends, as goals to be achieved, or negative ends, as things we must avoid doing. If there is a categorical imperative, this will be the end we envision. What would this end be? According to Kant "man, and, in general, every rational being exists as an end in himself."[37]

This gives rise to Kant's second principle, the Formula of Humanity: "*Act in such a way to treat humanity, whether in your own person or in the person of any other, never simply as a means, but always at the same time as an end.*"[38] Korsgaard applies this principle to condemn institutions and individuals who employ tools of

[35] Christine M. Korsgaard, *Creating the Kingdom of Ends* (Cambridge: Cambridge UP, 1996), p. 14.
[36] Kant, *Groundwork of the Metaphysic of Morals*, p. 94.
[37] Korsgaard, *Creating the Kingdom of Ends*, p. 16.
[38] Kant, *Groundwork of the Metaphysic of Morals*, p. 96.

deceit or coercion to compel people to act in a way that violates free choice.[39] In her book she denounces compulsion and fraudulent practice as the worst offences against others.[40] Kant's second principle is worthy of being enshrined in banking codes of ethics. Chapter 6 will probe into misleading and deceptive procedures that have been perpetrated in some of the American banks. These would run counter to the categorical imperative.

Having proffered the first two tenets, Kant presents the third principle, the Formula of Autonomy:

> ...the ground for every enactment of practical law lies *objectively in the rule* and in the form of universality which (according to our first principle) makes the rule capable of being a law...; *subjectively,* however, it lies in the *end;* but (according to our second principle) the subject of all ends is to be found in every rational being as an end in himself. From this there now follows our third practical principle for the will – as the supreme condition of the will's conformity with universal practical reason – namely, the Idea *of the will of every rational being as a will which makes universal law.* [41]

As Korsgaard points out, we rational humans decide our ends, and since a rational creature cherishes rational nature as a goal in itself and with this objective in mind we only act on principles that could become universal laws, we are therefore the ones who legislate these laws for ourselves. This is our autonomy.[42]

In Kant's view the formula of autonomy is fundamental to the categorical imperative because moral obligation is unconditional. Duty cannot be heteronomous, because, if the command is hypothetical or premised on a condition, either of a reward or a punishment, we have the option of complying due to our accord with the

[39] Korsgaard, *Creating the Kingdom of Ends*, p. 17.
[40] Ibid., p. 141.
[41] Kant, *Groundwork of the Metaphysic of Morals*, p. 98.
[42] Korsgaard, *Creating the Kingdom of Ends*, p. 22.

proposed condition or rejecting it due to our refusal of the condition. "There can only be one condition why human beings must obey the moral law, and that is that we give that law to ourselves."[43]

Kant then progresses to his concept of the *Kingdom of Ends* by which he means:

> A rational being belongs to the kingdom of ends as a member, when, although he makes its universal laws, he is also subject to these laws. He belongs to it as its head, when as the maker of laws he is himself subject to the will of no other. The practical necessity of acting on this principle – that is, duty – is in no way based on feelings, impulses, and inclinations, but only on the relation of rational beings on one another, a relation in which the will of a rational being must always be *making universal law,* because otherwise he could not be conceived as *an end in himself.*[44]

Kant presents us this ideal concept to which all of us must aspire as rational beings, because constant observance of the three categorical imperatives with the full understanding that they would govern everyone in society, including ourselves, would lay the groundwork of morality.

G. Categorical Imperative in Banking Ethics

The review of Kant's Categorical Imperative can lead one to advocate it as a means of defining obligations and duties for bankers, who may choose to incorporate them in their codes of banking practice. They are especially relevant for enactment of banking regulations. The business ethicist Norman Bowie wrote of the high suitability of employing Kant's practical philosophy to business conduct. As a

[43] Ibid., p. 23.
[44] Kant, *Groundwork of the Metaphysic of Morals*, pp. 101-02.

demonstration of the universal model Bowie referred to the nearly complete reliance on contracts in the modern world. Contracts are agreements on performance between various parties, which may be between companies and their customers, management and employees, purchasers and suppliers, landlords and tenants, corporations and governing states. If a maxim allowing infringement of contracts were to be endorsed as a universal law, it would spell the end of contracts. A universal maxim sanctioning breach of contracts would be destructive and therefore untenable.[45]

Contracts are, of course, the very foundation of all banking: taking deposits from the public, extending personal and home mortgage loans, foreign exchange dealing among dealers in multitudinous financial institutions, and corporate finance. When individuals place savings deposits at a bank, they enter into a contract with the institution in the form a passbook assuring them that they will receive defined interest earnings and also that they can withdraw their funds anytime. They trust the bank to honour its commitment under the contract. When they lose their trust in the bank's ability to perform under this contract, they rush to pull out their funds and, as we have seen repeatedly during the financial crisis that commenced in 2007 and continued to rage in 2009, runs on bank have proliferated.[46] An essential moral duty of a bank is therefore one of abiding with all its contracts, which denotes that it must fulfil all its obligations to its customers and necessitates that the bank adhere to all prudential guidelines to ensure it is able to do so. This means avoiding precarious situations, or at least maintaining adequate controls, so that the funds under its management are always protected.

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[45] Bowie, *Business Ethics: A Kantian Perspective*, p. 16.

[46] The large UK mortgage lender, Northern Rock, suffered a severe bank run in 2007 and had to be taken over by the UK government. The large Washington Mutual Bank likewise lost so many deposits that the US Federal Deposit Insurance Corporation was forced to engineer a takeover by the much larger JP Morgan Chase Bank.

A vital categorical imperative for a bank is to always act honestly. The requirement is for transparency in its dealings with customers, staff, and all other stakeholders. In a world where dishonesty could evolve into a universal maxim, customers would no longer trust banks, and banks would not trust one another.

The Kantian method of analysing whether a maxim can be universalised is therefore an approach that we can intuit and confirm in our everyday lives. The world would not function if we accepted that people do not have to keep their promises or tell the truth, because in that situation nobody would trust each other and there would be no interpersonal exchange. Corporations and banking would not even exist. Our reason and experience tell us that the reverse is true, that trustworthiness in keeping our word and honesty are ethically good.

Another principle that we all accept as vital in all human action is fairness, whether we consider sports, schools, government services or the business environment. In most of these endeavours we have to compete among each other for scarce resources and rewards, such that some are more successful than others, but we must do so fairly. In sports there is normally one victor and several losers in a given event; even though in business competition there can be several winners, there is usually one firm that fares better than the rest. Regardless of the outcome the participants must avoid all forms of cheating.

With regard to Kant's Formula of Humanity Bowie noted that merely abstaining from coercion and trickery is inadequate because this is negative freedom. "Positive freedom...means developing one's rational and moral capacities. In interacting with others, we must not do anything to diminish or inhibit these uniquely human capacities."[47] The dignity of persons arises from their autonomy and reason, which is the reason that Kant says we must always treat persons as ends-in-themselves. Bowie expounded on the need to respect persons in the organizational structures of workplaces in such a way that they are encouraged to grow to their full potential. He wrote on the application of this maxim in labour contracts, designing meaningful work, and a morally based profit sharing plan.[48]

We are conscious of the reality of this principle in our daily lives when we treat our spouses, partners, children, friends and relatives as persons whose identities we respect and love, and when we show consideration for work colleagues and strangers because they are fellow human beings. The contradiction, disrespect for persons, if it were a universal principle, would make life intolerable. It is clear that respect for persons is a moral obligation for all.

Looking at the situation of banks, one would refine the maxim so that banks should make it their duty to develop and enhance the rational and moral capacities of their employees, who in turn will be motivated to act in similar manner towards all their customers. In this way banks can respect the humanity in all people.

The British philosopher Onora O'Neill raised an important practical measure of treating others as persons in whether they give their "*actual consent* to actions that affect them as morally significant."[49] As O'Neill points out, obvious cases of false consent occur under duress such as in rape or seduction. But even in formal procedures, such as affixing signatures, consent can be voided even if the intent of the

[47] Norman E. Bowie, "A Kantian Approach to Business Ethics," in *A Companion to Business Ethics*, ed. Robert E. Frederick (Blackwell, 2002).
[48] Ibid.
[49] Onora O'Neill, *Constructions of Reason (Explorations of Kant's Practical Philosophy)* (Cambridge, New York: Cambridge UP, 1989), p. 106.

documents does not conform to the understanding of the persons concerned. This could arise due to misrepresentation on one side or ignorance on the other side.[50]

Another difficulty "arises when the consent does not match the activities it supposedly legitimates." O'Neill gives an example of women in modern societies who have chosen marriage but have not really consented to a restriction of their life.[51] She also cites the problems of patients in medical ethics whose "abilities to consent and dissent are impaired."[52]

All these difficulties transpire regularly in banking situations, so it is critical that bankers always deal with customers as persons. It is hypothesized in this thesis that a significant number of bank customers, especially those who are vulnerable due to economic, social, or age factors, are not able to give full consent to many contracts required in banking transactions.

For the third formulation of Kant's categorical imperative Bowie proposed the establishment of the business firm as a moral community modelled according to the kingdom of ends. He suggested seven principles in the structure of such a company of which the most important are consideration of the interests of all stakeholders in every decision, primacy of the first two categorical imperatives in adopting any policies, and supremacy of justice in stakeholder relationships.[53] While the kingdom of ends might have been construed as an ideal, several of the tenets put forward by Bowie have been espoused by some of the most admired corporations in their codes of ethical conduct.

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[50] Ibid., p. 107.
[51] Ibid., p. 107-08.
[52] Ibid.
[53] Bowie, *Business Ethics: A Kantian Perspective*, p. 90.

Altman objected to a Kantian construct in business ethics because he contended that only persons could be moral agents with intentions and therefore a corporation, which, according to him, lacks intentionality and the capacity to reason, cannot be held morally accountable from a Kantian perspective.[54] However, Peter French has taken the contrary position that corporations are intentional actors, which is necessary and sufficient for them to be deemed morally responsible.[55] French contends that all corporations have well-defined internal decision-making systems that set the ground for ascribing moral agency to them.[56] Soares agrees that corporations are morally responsible:

> corporations have rational reasons for behaving in certain ways because they have interests in pursuing their established corporate goals despite the temporary, conflicting self-interests of managers and directors...corporations are intentional actors, capable of being motivated to respond not only to internal challenges, but also to external ones.[57]

The observation of Soares is especially relevant to the banking sector where a corporation through its board of directors deliberates and promulgates policies and procedures for implementation throughout the institution, but these issues are usually debated vigorously by the different competing groups before decisions are taken that reflect the most convincing arguments. Such a decision system reflects rational behaviour.

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[54] Matthew C. Altman, "The Decomposition of the Corporate Body: What Kant Cannot Contribute to Business Ethics," *Journal of Business Ethics* 74 (2007): p. 254.

[55] John R. Danley, "Corporate Moral Agency," in *A Companion to Business Ethics*, ed. Robert E. Frederick (Blackwell, 2002).

[56] Peter A. French, "Corporate Moral Agency," in *Blackwell Encyclopedic Dictionary of Business Ethics*, ed. Patricia Werhane and R. Edward Freeman (Cambridge, MA: Blackwell, 1997), pp. 148-51.

[57] C. Soares, "Corporate Versus Individual Moral Responsibility," *Journal of Business Ethics* 46, no. 2 (2003): p. 145.

H. Social Contract Theories

H. 1. Contractarianism

Although theories of the social contract, also known as *contractarianism*, were principally advocated by Hobbes, Locke, and Rousseau, the ideas of Kant also had significant influence.[58] Contractarianism is a normative approach to development of moral action. As initially formulated, contract theories sought to explain the legitimacy of governments that stemmed from the consent of those governed formulated in a social contract, which becomes the foundation of moral norms. The key elements are the initial imaginary position, when mutual agreement was reached between people and those who would govern them, and the portrayal of the parties to the pact in terms of reason and inclination to reach an accord.

While the Hobbesian 'state of nature' and the Rawlsian 'original position' are hypothetical and the social contract theory has generated the greatest impact on political philosophy, it is applicable as well to business ethics. It is well suited to an analysis of ethical behaviour in banking because banks perform a vital function in every society and therefore operate under both implicit and explicit contracts vis-à-vis all stakeholders, who include, among others, customers, employees, the community, and shareholders. Since the start of banking history people have turned to banks to deposit their savings, which have been derived from earnings from their labour or sale of their production or rental from their properties; in turn, the banks accept their roles as custodians of individuals' wealth and undertake an explicit contract of responsibility to safeguard those assets. On the other hand, banks seek their income by lending out these funds to other members of society who lack savings and, in these

[58] John Rawls, *A Theory of Justice* (Cambridge, MA: Harvard, 1971), p. 11.

dual roles, carry out the crucial function of financial intermediation between sources and users of money. In their lending task they continue to retain explicit responsibility for prudently managing the assets with which they are entrusted and in addition assume prudential accountability for selecting appropriate borrowers. Therefore banks are expected to carefully screen prospective borrowers to ensure they have the financial capability to repay their debt.

Contractarian theories assume that the contracting parties are rational and self-interested without necessarily caring about the welfare of others. There is furthermore the presupposition that such persons desire social interaction provided there is no requirement for self-sacrifice.

Since its inception the banking state of affairs has always involved, on the one hand, powerful banks which have had access to significant capital in order to demonstrate trustworthiness and, on the other hand, customers who either have surplus funds or need thereof. Even within a contractual agreement this has primarily been a relationship between unequal parties, so therefore regulatory authorities have been involved as participants in this social contract since early historical episodes in order to protect the interests of individual depositors and borrowers. Relying upon both the explicit and implicit social contracts between banks and society, most national regulators have either written well-defined rules and guidelines or implemented a less rigid consultative system with recurrent reporting requirements.[59]

The problems with the contractarian theory are highlighted by counter-arguments of potential dilemmas arising out of either passions or rationality. Jean

[59] In Part B, which examines the empirical research, there is an examination of conditions in Australia, where the banking regulations have evolved into a stringent prudential system, as well as the situation of the Hong Kong Monetary Authority, which relies on a 'light touch' approach similar to that of UK banking regulators.

Hampton in commenting about rational choice noted the assumption of self-interest in contract theory when she compared the approaches of Hobbes and Kant.

> ...whereas the Hobbesians' use of contract language expresses the way in which moral and social policies should be rationally defined and defended, based on the interests people happen to have, the Kantians' use of the contract is a way of expressing the idea that moral and social policies should be both rational and respectful of each person's equal, autonomous nature. For Kant, what is moral should also be rational; but what is rational may not be moral, and thus he insists that our social and political life should insure that rationality prevails within moral constraints...Kant insists that moral constraints are generated by the equal importance each of us has as end-in-ourselves...[60]

When one views banking practices from Hampton's perspective, it seems obvious that most firms normally operate with the objective of profit optimisation, which in some circumstances is detrimental to the interests of their customers, so this provides the rationale for introducing consumer protection.

In his essay "*Reason and Maximization*" David Gauthier argues for moral constraint. He acknowledges that economic man normally assumes a system of straightforward maximization, but, if we distinguish him as a rational creature, we must instead expect that he agree to restraints. If one accepts that morality is rational, or at least does not go against reason, and morality implies some constraint on one's designs, then the only option is to consent to limits on optimisation. On such a basis of constrained maximization, as Gauthier asserts, "it is rational to restrain one's pursuit of one's own aims to fulfil an agreement to seek an optimal outcome unattainable by independent utility- maximization."[61] Such optimal behaviour might be described as the desired outcome in the Prisoner's Dilemma.[62] There are several

[60] Jean Hampton, "Rational Choice and the Law," *Harvard Journal of Law & Public Policy* 15, no. 3 (1992): p. 667.
[61] David Gauthier, *Moral Dealing* (Ithaca and London: Cornell UP, 1990), p. 233.
[62] Rawls, *A Theory of Justice*, p. 269.

situations in life where straightforward optimisation is not the best solution, and the Prisoner's Dilemma is a good illustration.

A very important insight provided by Gauthier is that "*morality arises from market failure.*"[63] He argues that the world might be a better place if it were a perfectly competitive market, which indeed cannot be found in the real world. In an idealistic *laissez-faire* there would be no need for moral constraints. As the actual evidence will demonstrate in the case study, the problem of American bank regulators for at least the decade until 2007 was their unequivocal faith in the power of free market forces. As Gauthier says: "Conceived as an ideal type, the perfect market...guarantees the coincidence of equilibrium and optimality, and so its structure is the very antithesis of the Prisoner's Dilemma."[64]

H. 2. Contractualism

A different approach to the social contract has been labelled contractualism. A contractarian would seek to maximize his own interests in dealing with others. A contractualist pursues his own goals in a manner that he can justify them to others who are seeking their own goals.

"The prisoner's dilemma (attributed to A. W. Tucker) is an illustration of a two-person, non-cooperative, nonzero-sum game; non-cooperative because agreements are not binding (or enforceable), and nonzero-sum because it is not the case that what one person gains the other loses. Thus imagine two prisoners who are brought before the attorney general and interrogated separately. They both know that if neither confesses, they will receive a short sentence for a lesser offence and spend a year in prison; but that if one confesses and turns state's evidence, he will be released, the other receiving a particularly heavy term of ten years; if both confess each gets five years. In this situation, assuming mutually disinterested motivation, the most reasonable course of action for them – that neither should confess – is unstable. To protect himself, if not to try to further his own interests, each has a sufficient motive to confess, whatever the other does. Rational decisions from the point of view of each lead to a situation where both prisoners are worse off."

63 David Gauthier, *Morals by Agreement* (Oxford: Oxford UP, 1986), p. 84.

64 Ibid., p. 83.

Under the Kantian perspective we must always treat persons as ends and not merely means, whereas contractualists try to identify moral doctrines that all rational agents would accept under certain conditions. Two contemporary philosophers, Thomas Scanlon and John Rawls, present varying contractualist systems. Rawls speaks of justice as fairness for which he states two principles.

> First: each person is to have an equal right to the most extensive basic liberty compatible with a similar liberty for others.
> Second: social and economic inequalities are to be arranged so that they are both (a) reasonably expected to be to everyone's advantage, and (b) attached to positions and offices open to all.[65]

The first principle makes a case for providing fundamental rights and liberties to every person without encroaching on anybody's liberties. Under the second principle according to Rawls "the distribution of wealth and income...must be consistent with both the liberties of equal citizenship and equality of opportunity."[66]

Rawls employs a unique approach whereby he formulates an assumption that the parties are situated behind a *veil of ignorance.*

> They do not know how the various alternatives will affect their own particular case and they are obliged to evaluate principles solely on the basis of general considerations...no one knows his place in society, his class position or social status; nor does he know his fortune in the distribution of natural assets and abilities, his intelligence and strength...nor his conception of the good, the particulars of his rational plan of life, or even ...his aversion to risk or liability to optimism or pessimism...the parties do not know the particular circumstances of their own society...its economic or political situation, or the level of civilization and culture...(nor) to which generation they belong.
> ...the only particular facts which the parties know is that their society is subject to the circumstances of justice and whatever this implies.[67]

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[65] Rawls, *A Theory of Justice*, p. 61.
[66] Ibid.
[67] Ibid.

When people situated in the '*original position*' behind a *veil of ignorance* are forced to negotiate a social contract, they must ask themselves how to distribute the benefits and burdens of social cooperation given that they are ignorant of who they are and yet are members of this society. Because each individual realises he could turn out to be anyone, he would be inclined to care for all people. According to Rawls, self-interest is transmuted by a veil of ignorance into a commitment to justice, which he takes to mean as fairness to all. Indeed, if all bankers were to think that they could be on the receiving end of actions they carried out, then they would be highly inclined to ensure fairness at all times.

Scanlon differs in that his theory does not bring a veil of ignorance into play. The individual is aware of his personal circumstances but in lieu of self-interest has a compulsion to justify himself to everyone else. According to Scanlon there is a fundamental moral impulse behind the need of individuals to justify themselves to others.

Scanlonian contractualism varies from utilitarianism in several respects. It concerns itself with what we owe to each other, not with all questions of morality. It also looks at individuals rather than net results for a total population. Instead of looking at happiness or well being as the basis for a moral code, it acknowledges personal reasons. While utilitarianism looks at aggregating utilities to evaluate if there might be greater happiness than harm caused, contractualism looks at each unique individual. As Scanlon says:

> ...our thinking about right and wrong is structured by a different kind of motivation, namely the aim of finding principles that others, insofar as they too have this aim, could not possibly reject. This gives us a direct reason to be concerned with other people's points of view: not because we might, for all we know actually *be* them, or because we might occupy their position in some other

> possible world, but in order to find principles that they, as well as we, have reason to accept.[68]

The actions of contractualist individuals stem out of self-regard as well as respect for others. A component of what we owe others is support for their interests.

Some bankers might suppose that they have adopted an analogous process through their corporate social responsibility programmes, but these fall short of true contractualist principles. These activities are intended to provide support to the communities but many of them appear to be public relations exercises, some of which entail sponsorship of musical performances and sporting events. It would seem to external observers that there is only nominal effort at some banks to find out what would truly benefit each person, in contrast to an aggregative utilitarian approach of funding for entertainment, which has its appeal in producing more 'happy' people than 'unhappy' ones. However, as will be discussed in Chapter 3, there are some financial institutions that profess contractualist principles and seem to genuinely care for all stakeholders.

H. 3. Social Contract Methodology in Business Ethics

Tom Donaldson was the first one in 1982 to apply the social contract approach to business ethics in his inquiry into the features of corporate obligations. He found that only contractarianism could serve as a practical concept in business ethics, while other philosophical ethical theories were too general for application to the business

[68] T. M. Scanlon, *What We Owe to Each Other*, 2nd ed. (Cambridge, MA: Harvard, 1998), pp. 4-5.

environment.[69] Donaldson and Dunfee subsequently modified their concept into the Integrative Social Contracts Theory (ISCT), which relied on a "hypothetical social contract used as heuristic device and extant social contracts based within living communities."[70]

Donaldson made two assumptions in the ISCT. Firstly, he assumed that the contracting parties are aware and supportive of "bounded moral rationality", which brings the concept of bounded economic rationality to the ethical level.[71] This is similar to the position of Gauthier that we saw above wherein he said that rational man would accept a constraint on economic maximization.

The second assumption in the ISCT is that global contracting parties would, in acknowledgement of bounded moral rationality, appreciate the "need for a community-based moral fabric for both the generation of wealth and the maintenance of an environment conducive to a good and productive life."[72] Given these two assumptions the important questions are whether the members of the community have truly consented to the terms of the covenant and whether their consent was freely given, with sufficient information and no intimidation.

Since the terms of such a covenant in a corporation would be embodied in a corporate code of ethics, the question therefore arises as to how well such a code represents the ethical norms of that community. Donaldson believes that the social contract approach is compatible with other ethical theories, including utilitarianism, deontology, and virtue ethics.

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[69] Thomas Donaldson and Thomas W. Dunfee, "Social Contract Approaches to Business Ethics: Bridging The "Is - Ought" Gap*," in *A Companion to Business Ethics*, ed. Robert E. Frederick (Blackwell, 2002).
[70] Ibid.
[71] Ibid.
[72] Ibid.

Marens recently commented on the methodology supported by Donaldson and Dunfee, arguing that there was a need to revert to the Rawlsian intent of *justice as fairness* that requires active government involvement in order to promote social justice. Marens observed that the norms and values in the financial industry did not avert socially damaging conduct as soon as enforcement of regulations was downgraded and government assumed a permissive attitude. He claimed therefore that active involvement of government is necessary in order to ensure social justice and safeguard the interests of the weaker members of society.[73]

I. Virtue Ethics

Several philosophers assert that ethical theories and codes of conduct derived from them are not much help on the practical level, that universal knowledge of what is right has limited value[74] and that Aristotelian *Phronesis* or practical wisdom is the essential virtue because, according to Aristotle, it is "concerned with action about things that are good or bad for a human being...Virtue is intrinsic to the human being and comes naturally without application of ethical rules."[75] Moberg defined practical wisdom as "a disposition toward cleverness in crafting morally excellent responses to, or in anticipation of, challenging particularities." He relies on Aristotle's meaning of

[73] Richard Marens, "Returning to Rawls: Social Contracting, Social Justice, and Transcending the Limitations of Locke," *Journal of Business Ethics* 75, no. 1 (2007): p. 72.
[74] Daniel Nyberg, "The Morality of Everyday Activities: Not the Right, but the Good Thing to Do," *Journal of Business Ethics* 81 (2007): p. 587.
[75] Aristotle, *The Nicomachean Ethics*, ed. N. Krezmann, G. Nuchelmans, and L. M. De Rijk, trans. Hippocrates F. Apostle, vol. 13, Synthese Historical Library (Dordrecht, Holland: D. Reidel 1975), p. 21.

moral excellence as that established by moral communities consisting of individuals who strive to lead good lives.[76]

Along this line of thinking Moberg wrote: "Morally excellent action requires doing the right things in the right way to the right extent to the right person at the right time for the right reason."[77] This approach tells us that the importance lies in a person's character, in what he or she has made a habit in day-to-day living. The average person does not need to have studied or learned ethics in a classroom or in a corporate seminar to know that it is wrong to do certain actions: to lie, to steal, to cheat others on the basis of rules and regulations everyone has accepted, to cause injury to others. In fact, most people would not have studied ethical principles before embarking on their careers or during the course of their lives, but they know intrinsically what are good and bad actions.

Since virtue is developed through habitual action, Nyberg conducted his empirical research on everyday work practices at two Australian call centres to determine how the employees handle routine tasks that require ethical responses. He found that it is possible to inculcate phronesis or practical wisdom in the work place when workers discuss cases, share experiences, and evaluate alternative solutions. He discovered that these situations encouraged people to choose ethical conduct whereas ethical codes and regulations only gave rise to compliance but could not cover all possible dilemmas. He concluded that companies should develop practical wisdom among employees by having them question and reflect upon ethical codes so that they

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[76] Dennis J. Moberg, "Practical Wisdom and Business Ethics," *Business Ethics Quarterly* 17, no. 3 (2007): p. 536.
[77] Ibid.

understand good action and take responsibility for making their own moral decisions.[78]

Moberg stated that practical wisdom must be grounded in a person's "desire for moral excellence...that the person has a strong moral self, i.e. the person highly values integrity as a self construal...[and has] a disposition to take responsibility for the good in situations."[79]

J. Specific Concerns in Finance and Banking Ethics

Although not much has been published exclusively about banking ethics on its own, John Boatright,[80]a business ethicist, has written several critical analyses of finance ethics, which encompasses three spheres of activity: financial markets that are comprised of trading in all forms of currency, debt, equity, and hybrid or synthetic instruments; financial services that are offered by financial intermediaries such as commercial and investment banks; financial management which is the role in a corporation concerned with boosting shareholder wealth.

The entire arena of finance impacts on the economy and society and is therefore closely regulated in all countries. However not all ethical concerns can be covered by laws. In financial markets legal provisions are concerned with ensuring fairness and preventing fraud. In financial services the ethical concerns relate to

[78] Nyberg, "The Morality of Everyday Activities: Not the Right, but the Good Thing to Do," pp. 596-97.
[79] Moberg, "Practical Wisdom and Business Ethics," p. 542.
[80] John R. Boatright, "Finance Ethics," in *A Companion to Business Ethics*, ed. Robert E. Frederick (Blackwell, 2002).

fiduciary responsibilities. Financial management issues relate to good corporate governance that considers all stakeholders.[81]

Boatright noted that a principal cause of unethical behaviour in financial intermediaries is conflict of interest when banks and their employees place their own interests ahead of those of their customers. He pointed out that trust is critical in financial services.[82] The empirical research and the case study in this thesis certainly validate the persistence of conflicts of interest in banks and the frequent breaches.

Duska and Clarke agreed that a major apprehension in financial services stems from conflicts of interest.[83] They drew attention to two important ethical principles that ought to be practised in most cases of financial services, namely: avoid deception and fraud, and honour one's commitments.[84]

The philosopher Robert Solomon emphasized the importance of trust in all human relationships, asserting "the fact that trusting is an ongoing process, a reciprocal (and not one-way) relation in which both parties as well as the relationship (and the society) are transformed through trusting."[85] He went on to elucidate that trust is often confused in business with a contractual relationship. Solomon criticised the business practice of thinking of contracts as the basis of trust because it could be argued that contracts often indicated lack of trust. Solomon pointed out that with the inclusion of enforcement provisions and sanctions, "it would seem that a contract is

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[81] Ibid.
[82] Ibid.
[83] Ronald F. Duska, James J. Clarke, "Ethical Issues in Financial Services," in *The Blackwell Guide to Business Ethics*, ed. Norman E. Bowie (Blackwell, 2001).
[84] Ibid.
[85] Robert C. Solomon, "Trusting," in *Heidegger, Coping, and Cognitive Science: Essays in Honor of Hubert L. Dreyfus*, ed. Mark Wrathall and Jeff Malpas (Cambridge, MA; London, UK: MIT Press, 2000), p. 234.

both more and less than merely a trusting agreement. It is protection based on distrust."[86]

Trust is extremely important in banking because people must place their trust in a financial institution before they accept any financial services; banks must likewise trust their customers and treat them as persons when they offer their services, whether taking deposits or extending loans; banks should earn the trust of other financial institutions if they are to successfully obtain funding in the inter-bank market.[87] As Chapters 6 and 7 will demonstrate, a breakdown of trust was part of the reason for the collapse of the global credit system.

This chapter has discussed how philosophers have viewed ethical theories on money and endeavours to earn profits thereon. There was the ancient proscription by Aristotle against receiving interest on money that continued into the Middle Ages in the Christian churches and till the present time in the Islamic faith. With the spread of banking services interest payments gradually became more socially and religiously accepted (though not in Islamic fundamentalism).

Ethical theories were investigated: some defined the right action in terms of the maximum amount of utility and happiness it could bring, or what became know as utilitarianism, which sought to establish moral conduct for individuals; some approaches argued for freedom from government controls in favour of the pursuit of self-interest with the contention that good consequences would inevitably result from laissez-faire; others invoked universal principles that could be gleaned through reason in the Kantian tradition that sought to identify duties that were incumbent on

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[86] Ibid., p. 238.

[87] Normally banks can only fund a small proportion of their loans out of customer deposits and capital and must therefore borrow funds from investors either through issuance of bonds or short-term notes of indebtedness or other forms of debt securities.

individuals. Finally there were arguments in favour of virtue ethics or practical wisdom as a necessary virtue that ought to be encouraged in workplaces.

While the aim of this thesis is to determine the ethical underpinning of banks, there is a realization that many philosophers and ethicists advocate specific theories that ought to govern the conduct of firms and banks. In trying to discover the ethical considerations, there is the recognition that pluralistic ethical motives might be operative in the actual way of thinking and practices of bankers. This might suggest that individuals and institutions rely on a combination of varying ethical perspectives that include, for example, deontological considerations in designing codes of conduct, utilitarianism in planning products, virtue ethics in situational problems. The empirical research and the case study will highlight different ethical concerns, many of which are the same across the various theories that have been discussed. Many of the concerns will reappear in the empirical material independently of their ethical elaboration. This implies a basic ethical framework is in place that is relatively robust even in the face of variations in metaethical position. Therefore a framework of three principal values is proposed as essential for a bank that truly espouses ethical conduct: *responsibility*, *fairness*, and *honesty*.

Banks have diverse obligations: to the regulators in terms of compliance, to shareholders in observing good corporate governance and achievement of corporate goals including profitability, to other stakeholders including employees and communities so that their needs are satisfied and they are adequately protected. Above all, a strongly held opinion is that most important is the moral responsibility of a bank towards its customers. The next chapter will explain that, on the one hand, individuals need and trust their bank, and, on the other hand, a bank would not exist without its customers. A responsible institution must therefore consider possible future eventualities that could affect its customers because only by looking after customers can it maintain its integrity and demonstrate its trustworthiness.

A bank should treat all its customers fairly so that no individual or entity is disadvantaged. It is an economic reality that there are gross economic inequalities among individuals, corporations, and nations. The gravest drawbacks afflicting individuals are economic hardship, which renders them prone to manipulative practices by unscrupulous bankers, and financial illiteracy that could lead to their inability to comprehend the intricacies of financial packages being offered to them.[88]

Transparency or honesty is a value that everyone regards as highly important in any bank, in its reporting to its shareholders, in its interaction with its community and employees and other stakeholders, and most specially in its dealings with its customers. A bank should clearly explain the risks and returns, benefits and potential losses of every financial product it proposes to each and every customer. As an integral component of this transparency the bank and its employees should declare their actual and prospective financial interests, that is, how much they would receive by way of commissions and bonuses if the customers were to accept the financial products on offer.[89]

The above-stated values of responsibility, fairness, and transparency are what would be expected of ethical persons and institutions in every society. Therefore the same principles should be applied in examining banking conduct, and higher standards should be demanded due to the trust that customers place in banks.

[88] This will be further analysed in the subsequent discussion of the sub-prime crisis.
[89] There will be references to excessive bonuses in the chapter on the crisis.

Part B. The Idea of Ethics in Banking: Self Conceptions and Critique

CHAPTER 3. ETHICAL UNDERSTANDING IN THE BANKING SECTOR

Chapter 2 discussed the development of modern banking and the case was made that banks occupy a central role in society and that their services are essential to communities. The previous chapter also briefly reviewed the dominant ethical theories as they relate to the banking sphere. Part B will examine the way in which the bankers themselves view their activities. Before and after the interviews undertaken with bankers much publicly available material has appeared in press releases from the banks or speeches or interviews given by prominent bankers. Certain banks also publish reports on their corporate social responsibility activities. Therefore the general public has been regularly treated to stories that banks' publicists wish to circulate. On the other hand, some investigative reporters have frequently unearthed and written about alleged unethical conduct of banks. The purpose of these interviews was primarily to engage with senior bankers in an earnest dialogue about their views on banking and about actual banking conduct. In view of the vast scope of banking a decision was made to limit the focus to banks in Australia and Hong Kong for the interviews. Two sets of common interview questions were designed that were submitted in advance to the selected banks. One set was intended for chief executives or other senior line executive officers.[90] The other set was geared

[90] Appendix A.

to operational staff executives responsible for back-up or support operations.[91] Both questionnaires are attached as appendices. In some instances written responses had been prepared prior to the meetings. In many situations there was a lively interactive discussion with the bankers.[92]

Many institutions were highly cooperative in providing the opportunity to meet with several individuals who each had varying organisational responsibilities and consequently diverse perspectives. Although most of the organisations interviewed were long-established banks, a few were not. These included a credit union (which would later merge with another one), a former community bank that has evolved into a full-service commercial bank (and would later acquire another institution), a major international non-bank lender that did not depend on customer deposits for its funding, senior bank association representatives from Hong Kong and Australia, a banking ombudsman, and key officers of a banking regulator. The ensuing discussion shall analyse each of the key product areas and services covered during the interviews.

A. Retail Deposits

The interviews commenced with reviewing retail deposits because this is one product used by all individuals who avail themselves of banking services. One could actually say that it is a necessity for all people. This is the primary product that truly requires trust on the part of customers. Although most people in developed economies might assume that money and banking are stable, this has not been the historical experience,

[91] Appendix B.
[92] The transcripts of the actual interviews are presented in the attached CD.

and it is instructive to review the situation in Hong Kong, which has witnessed significant volatility over the recent quarter century, namely, 1981: interest rate of 22% (considered very high at that time); 1982: interest rate of 17 % (still high); 1983: Sino-British agreement on hand-over of Hong Kong and the steep drop of the HK$; 1987: stock market crash; 1991: bank runs on Citibank and Standard Chartered Bank; 1997: the Asian financial crisis and start of property collapse; 1998: the Hong Kong government's intervention in the stock market; 2000: the bursting of the Internet bubble, 2003: the SARS respiratory disease epidemic.[93] These were economic crises that precipitated financial panic on the part of bank customers and investors, and in having undergone and survived these numerous crises, the people of Hong Kong have matured.[94] During this process of maturation, a senior banker attested that many individuals have come to understand the nature of risks and are therefore very careful in their selection of banks.

In the view of some interviewees the banks in Hong Kong have emerged quite strong in coming through the disasters. The local individuals have also been imbued with the intangible notion that China supports the continuing stability of Hong Kong, an idea that was absent prior to the hand-over in 1997. This implicit understanding has been gradually cultivated as Hong Kong has drifted closer towards China in terms of trade and investments in both directions, and Chinese companies issuing initial private offerings on the Hong Kong Stock Exchange. A degree of comfort with the Chinese mainland has been nurtured among the Hong Kong people.

Within this context individuals have regained trust in banks. They have had good reason to trust the HSBC and the Standard Chartered, because these have both

[93] The global credit crisis that first struck America in September 2007 quickly spread to Europe and Asia, including Hong Kong and Australia. At the time of writing in April 2009 the whole world was in the grip of the worst recession since the Great Depression of 1930.
[94] Transcript HK 7.

been in existence in the previous colony for more than a century and a half, and they have come to accept that the Bank of China is fully backed by the Chinese government. They have also welcomed the small and medium-sized banks because the introduction of deposit insurance further solidified confidence in the banking industry. In the view of a former chief executive of Dragon Bank, Hong Kong has come out of these calamities as a major international financial centre; whereas it was previously considered as a rival of Singapore, it has emerged much stronger.[95]

A. 1. Trust

The Dragon Bank CEO in Hong Kong commenced the discussion with the avowal that the entire culture of the bank is founded on ethics and integrity; he recollected his first day in the bank some thirty years ago when he was taught that personal integrity is everything.[96] Over the years this current Dragon chief executive has often reflected, in this age of commoditized banking products, on what banks have to offer, what distinguishes them from each other and why customers would select one over another, and he has concluded that the key lies in trust. The task of a bank is to protect that trust.

In this regard, this Dragon banker equates trust with reputation. While he says that banks do a good job in managing risks, he deems the most important risk is that of loss of reputation. Most institutions highlight credit risk, market risk, operational risks, but not many talk about reputational risk. This CEO believes that Dragon Bank's reputation is factored by investors into its share price, thus explaining its price differential with another similarly large global financial group. The local institution

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[95] Ibid. Code names are used if reference is made to interviewed banks.
[96] Transcript HK 8. Code name = Dragon.

is not perceived as "progressive or dynamic" but rather as "conservative, safe, steady," one that relies on solid results but is self-effacing.

A. 2. Product Differentiation

One might think a retail deposit is a straightforward product that would be similar among all banks, but in reality each institution approaches it differently and offers a wide range of availability to suit a range of transactional needs of individuals. Banks target deposits heavily because these represent the lowest cost of funding that enables them to extend personal credit, housing loans, and corporate finance to other customers. These products come in various forms depending on the frequency of financial inflows and outflows for the depositors. Those individuals who tend to enjoy steady inflows and do not require all or most of the money immediately are especially courted by the banks with offers of attractive interest rates. These are frequently in the form of time deposits that require a reasonably sizeable minimum sum of money with a minimum deposit period. These are savings products that are structured similarly as investments, and are widely promoted in print advertising. The problem with these is that the individual has to either read the brochures carefully or be sure that the sales representative explains the features in comprehensible detail. Such advertising could sometimes be deemed misrepresentation on the part of the bank involved if it lacks transparency or the offers are deceptive. The depositor would normally forfeit the promised interest earnings if she were to withdraw funds prior to a pre-agreed termination date. An example occurred in 2006 when a major Australian bank was sued over its misleading newspaper advertisement for such a time deposit, causing it to promptly withdraw the ad. Many so-called higher yield accounts allow the depositor to occasionally transfer a portion of the funds on term deposit to an operating account that she would use to make normal payments, but the higher interest rates are forfeited.

Retail deposits have therefore become complex products requiring thick informational material so that their features can be adequately clarified. Bank sales personnel also need to receive good training. Marketing techniques are heavily utilised to promote the varying deposit types, which are typically provided attractive sounding brand names associated with the sponsoring financial institutions. There is intense competition among the banks to set interest rates for maximum appeal to prospective depositors. Reliance on a wide physical branch network has also been deemed a crucial factor in deposit gathering by most banks. The conventional wisdom is that people like to see a branch near their place of work or residence even if they might never enter the bank's premises. One exception has been a foreign bank, ING Direct[97], which has deliberately established itself as an online institution in Australia without any visible branches. To compensate for its lack of a physical presence it has reportedly offered higher interest rates.

The thinking of most banks is that products are commodities so they believe that decisions are based on price, which is why much bank advertising speaks about interest rates. However, based on its research, Kangaroo Bank, one of the major banks in Australia believes that only 20 – 30 % of people make their decisions fundamentally on the basis of price, which means that 70 – 80 % of customers select financial services according to non-price variables. This institution believes that other factors enter into these decisions.[98]

[97] This was not an interviewee.
[98] Transcript AU 4. Code name = Kangaroo.

The bank finds this an opportunity to do something for people (1) who find banking unnecessarily complex, or (2) who are time-poor. These are customers who feel confused and frustrated about the level of service they receive in terms of the human connection. This retail bank therefore stresses convenience, which is what clients experience when they are served well. This is about making it easy for them: not just how long the process takes but how they feel about the process. The head of consumer banking at Kangaroo Bank attributes the following line of thinking to retail banking clients:

> 'Do I feel I have been listened to? Do I respect the company with which I am dealing? Do I have to repeat myself all the time or do they remember things about me? Are they nearby and available either physically or virtually when I want them to be?'[99]

The bank tries to deliver a different experience to customers such that they genuinely feel it easy to deal with the institution. There are several ways of demonstrating this: longer hours, more conveniently located branches, better trained staff in branches – more empathetic and good listeners, products that are simpler to understand. Rather than merely making vague assertions about convenience, they give people tangible reasons to choose the bank that are not about price, such as (1) keeping a call centre open 24 hours a day, 7 days a week, which has won them an award as the best call centre of any company in Australia for three years in a row; (2) extending hours in all branches at major shopping centres; (3) opening new branches (40 in the previous 2 years, 40 more in 2006); (4) 500 new ATM's; (5) simplifying products, such as the new Visa debit card for those who do not have credit cards.

Kangaroo Bank has made its brochures slimmer by getting rid of excessive product complexity. It prefers to reduce the number of products rather than add new

[99] Ibid.

ones. In trying to simplify products it makes sure it addresses the core needs of customers and train their staff. Kangaroo realizes that most people do not like reading brochures. This bank has characterized its brand positioning in terms of convenience, simplicity, and responsibility.

Another feature of deposit accounts is the use of ATM (automated teller machine) or EFTPOS (electronic funds transfer at point of sale) cards to access one's account. *Australian* banks restrict ATM withdrawals and EFTPOS transactions to a total *maximum daily limit* of A$ 1,000 – 1,5000 regardless of how much in balances there might be in the customer's account. The reason given is the desire to protect the depositor in case the card is lost or stolen.[100] One might consider this unsympathetic to the individual customer and illogical because there is no such restriction on credit cards, which can likewise be lost or stolen.

In contrast, *Hong Kong* banks generally allow each deposit customer to withdraw cash up to HK$ 20,000 per day and transact up to HK$ 50,000 per day through a debit card for each account. Based on current foreign exchange rates on 5 September 2008 that maximum daily limit is equivalent to A$ 10,965.61. This is significantly higher than limits in Australia.

Why do Hong Kong banks allow average deposit customers to withdraw cash and execute cash transfers at a level in excess of ten times the amount permitted by their Australian counterparts? Perhaps the explanation comes from the practice of the motto *KYC (Know Your Customer), which was mentioned by all the study participants in Hong Kong. One could take the view that in the process of getting to know their customers these banks have also developed a relationship of trust.*

[100] Ibid.

One major bank, Lion, considers its brand name vital and advertises it extensively; it promises to deliver on the brand promise of being the *right partner*. The bank describes its values, which are reinforced daily in the institution, as creative, courageous, responsive, international, and trustworthy. Its self-image, the way it positions itself as being the right partner and leading the way in several continents, and these values are fundamental to the processes of the bank.[101]

Thus, when a prospective client walks in through the door, they expect that person to be the right client who fits within the target market because their marketing is focussed on select customers; they are not a mass marketer. Lion regards account opening a complex process because of strict procedures required for ascertaining identities and averting money laundering, but it has well-trained personnel who are able to assist new clients in picking the correct products.

Another significant bank will not even entertain an application for a deposit without a letter of introduction from an existing well-regarded customer of the bank. Due to its strong reputation and active marketing this bank attracts numerous customers that are serviced by its trained personnel who explicate the numerous complex financial products on offer. Having operated countless branches for a long period of time this group had developed strict internal standards on ascertaining the identities and states of affairs of their prospective clients before any requirements were embodied into guidelines or statutory rules. Because of this process of getting to know their clients well, it was straightforward for them, on the one hand, to meet customer demands, and, on the other hand, to comply with regulations on anti-money laundering and prevention of corrupt practices, when these were enacted. They believe that the bank has effective controls and monitoring procedures in place. The

[101] Transcript HK 3. Code name = Lion.

bank staff must develop the relationship with the new customers starting from the initial step of account opening while at the same time being fully aware of the customers' rights as well as the need to preclude fraudulent transactions. One would infer that it is this criterion and process of KYC that enables Hong Kong banks to set more generous cash withdrawal and transactional daily limits.

Although it was not included as a topic for discussion, the Dragon Bank CEO referred to private banking as an area that is potentially troublesome from an ethical perspective.[102] This belief probably stemmed from observations that private bankers tend to be obsequious toward their clients and inhibit themselves from asking questions on the origin or use of funds, which could very well be illicit. This CEO does not condone such practices. At the time of the Hong Kong interviews some newspapers reported that authorities were investigating substantial (possibly illegitimate) bank deposits under fictitious names that allegedly belonged to the former Chilean dictator Augusto Pinochet.

One may well agree that the attention and explanation given by retail personnel in a bank branch is extremely important in enabling clients to select the correct deposit product given its features and costs. An investigation of several branches of different banks will illustrate that there are frequent queues of people waiting for tellers so they can execute transactions. There are occasionally customer service representatives who assist in account opening or specific problems, though there may also be queues. The typical bank assistant could experience time pressure in having to attend to multiple tasks: getting to know the customers, not only in verifying identities but also in trying to learn about their financial needs and wishes; explaining product features, including costs and risks; effecting a sale of product or

[102] Transcript HK 8.

service. While handling all these tasks the representative must likewise look after the interests of everyone else waiting to be served. There might be missed opportunities on the part of the banks because they never attempted to truly get to know the clients in order to understand how they could address their requirements. Worse still, the explanation provided to them might be inadequate and lead to ill-considered decisions.

One area where some banks display a pandering attitude towards depositors is the installation of ATM outlets at casinos and racetracks. A retired chief executive of a major bank, Kangaroo, commented that the dilemma is between controlling problem gambling and the individual's right to access his money when and if he wants it. He is therefore in favour of setting up ATMs at casinos because in his view "it is difficult to protect people against themselves."[103] One may judge this as an ethically irresponsible attitude because it greatly facilitates gambling particularly for individuals who may not be aware of the risks or their possible addiction to this vice. Conversely it was appropriate ethical thinking behind the decision of a credit union to refuse to install ATMs at casinos; the institution considered it wrong to make it easy for customers to withdraw cash in order to gamble.

Two Australian banks, which consented to interviews, were encouraging in the manner they differ from other institutions. Quoll is a newly licensed medium-sized bank catering principally to individuals and small and medium scale companies. Its distinguishing characteristic is its ownership by pension funds and employee groups, which shapes the underlying values of the organisation.[104]

There are three principles that guide Quoll's operations:

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[103] Transcript AU 6. Code name = Kangaroo.
[104] Transcript AU 12. Code name = Quoll.

1. The payment of commissions is rejected in the remuneration of sales staff, so they are not compelled to achieve particular product sales targets.
2. There is a proactive cultural alignment, which ensures that the sales staff understand that their specific market is very distinct, consisting of members of unions and super funds and their families, working Australians, and that it is a privilege to have this relationship with them. There is a commitment to work with these stakeholders. This means that the sales personnel would not wish to tarnish their integrity or put it at risk by behaving in an unacceptable manner. This culture means that, if they sell a product that is not suitable for the customer and that person complains to his union or super fund, it could prove damaging for the bank. It is not in the bank's interest to sell a client something that does not actually meet his needs.
3. The bank is sufficiently confident about the structure and quality of its products and its values and business model so that it has no reservations about the appropriateness of its product offers for most people in most cases. In this respect, independent rating agencies have evaluated individual products as very good.

While keeping the above principles in mind, the bank competes with the market on interest rates. Its products have to be competitive not just in structure but also on service and price. One forms a positive view of this bank's avowal that the products it offers to customers are *simple, transparent and equitable.* This is an ethical stance that treats clients as persons. The effort to achieve cultural alignment between bank employees and customers is praiseworthy because it helps to foster integrity in the bank.

The other institution operated as a successful building society in its community for well over a century but several years ago it embarked on an assessment of its future direction, analysing its strengths and weaknesses and its external perception. The top executives desired a strategy that would differentiate the institution and provide added value to the customers and communities. The outcome of that strategy has been a highly unique and thriving banking practice. They felt that their strengths were the institution's community values and customer focus, but the drawbacks included limited brand recognition, restricted distribution and coverage, and a relatively small size, which precluded a fully conventional approach to expansion.

The building society's strategic review led it to conclude that banks were originally formed to help build affluent towns by managing the funds of those with excess capital and channelling them to those with creative ideas and aspirations but little capital. However research revealed that *present-day customers felt the current banking system was focused on its own objectives rather than those of customers or individual communities.*

This bank's CEO was aware that his institution's success was inextricably linked to the success of its customers and communities, so if they could assist the development and success of each town they could secure their own future success. These community bankers therefore directed their attention to the concerns of Australian country towns. They learned that most communities are exporters of capital and have little capacity and influence to retain or attract capital inflows. The community bankers believed that a new business model was required that would involve greater community participation and actualise better capital flow strategies. They realised that they would need to help re-create more self-reliant communities.

The community bank opted to build a world-class banking organisation for all stakeholders with an aim on contribution and with a clear difference. This gave birth to the concept of a community bank within a national network in which there are thousands of community directors and thousands more of 'local' shareholders. Each community branch takes the form of a limited public company whose investors are local people from within the community who have committed to buying into their proposed branch. One principal requirement of the bank is that the community demonstrate broad based community buy-in. Typically 250 – 400 individuals invest in the local company to establish their branch. The bank itself does not become a shareholder in this company but rather a highly committed business partner supporting the network.[105]

This community bank structure has created new employment, attracted numerous customers, and in many cases generated local profits and dividends for local shareholders and the community. While the community branches originate the business, loan officers in the bank proper make the credit decisions. As a result of the achievements of the franchise branches, the communities have received additional revenues that have enabled them to provide additional financial support to local entities such as schools, fire brigades, aged care homes, and business districts to attract professional services.

This is an example of a bank that has produced a triple bottom line success story as a result of its strategy to focus on the community while building a world-class bank with high-grade products. Such an approach, which is predicated on sustainability of the communities and the environment, has also brought the bank financial returns.

[105] Information supplied in email. Unfortunately there is no transcript because of the poor quality of the recording.

The chief executive stated that his bank does best in its being able to connect with its customers. He considers the bank's most important role is that of listening to what the customer needs. In this respect they are able to offer the right products for all customers. The community bank CEO proudly noted that in an earlier period they had introduced the access card or debit card to Australia, so that clients could easily gain access to their funds. In other words, it promoted convenience rather than reliance on financing from credit cards. This bank has been independently rated the *highest in customer satisfaction* among all financial institutions in Australia.

In the analysis of bank practices relating to retail deposits in both Australia and Hong Kong, bankers stress the importance of getting to know their customers well, listening to them, and trying to understand their needs, but what seems to distinguish the admirable ones is that they have imbued a culture within the organisations that encourages management and employees to relate to, and empathize with, their customers. These banks have cultivated trust.

B. Credit Cards and Personal Loans

From one point of view credit cards have been prime instruments of heightened consumer spending and increased levels of consumer debt. Banks and other financial companies compete fiercely for a slice of the credit card market with many of them freely giving away the cards with minimal credit checking on the prospective cardholders. Many institutions offer credit cards to young individuals, who most likely would still be in school or university with little or no means of independent income and would therefore be at risk if they incurred financial obligations.

Senior Hong Kong bankers at Rooster admitted that credit cards are a difficult problem area because of high acquisition[106] expenses of HK$ 400 – 500 per card, the servicing cost, and the write-offs which had risen to a peak of 11% of outstanding receivables but in late 2006 were at 3 – 4%. The acquisition expense relates to gifts presented to all new cardholders. Due to market competition and a desire to entice new customers they try to offer attractive gifts.

The youngest cardholders are 18 years old, which is the minimum legal age. Rooster is active among students, claiming to be the second largest at universities. The key acquisitions occur at road shows at locations oriented towards young people. Much of this bank's credit card income originates from the young customers, who tend to roll over their credit card obligations and are known as 'revolvers', unlike the professionals and mature ones, who normally pay their entire bills on time and are thus referred to as 'transactors'. The allusion here is that credit cardholders who are less capable of repaying the full amount of their obligations pay interest while those who earn more enjoy the benefits of interest-free credit during the period prior to the statement date. Needless to say, those who are most financially disadvantaged probably default on their payments, are charged penalties, and have to pay higher interest rates. This is a case of the poor subsidizing the rich.

Problems could potentially develop with cardholders who lack the self-restraint and overspend to the point that they have difficulty repaying their obligations, although these bankers commented that the Hong Kong customers used their credit cards primarily for convenience rather than borrowing. Some banks stated that, due to fierce competition, annual fees were usually *waived* in Hong Kong in

[106] Acquisition in this sense refers to the process of promoting the product through advertising, direct mail campaigns, cold calls in busy venues such as airports and shopping centres; it also includes various welcome gifts. Transcript HK 1. Code name = Rooster.

order to attract customers. But interest rates on credit card debt are very high in both Australia and Hong Kong and most other countries. As an example, it is deemed *illegal* to lend money in Hong Kong at an interest rate exceeding *60%* per annum under Section 24 of the Money Lenders Ordinance, while Section 25, which outlines procedures for court proceedings for both lenders pursuing delinquent obligors and aggrieved borrowers seeking debt relief, defines as *extortionate* any effective rate of interest exceeding *48%* per annum.[107] One would certainly consider rates at those ceilings to be usurious, but even the current effective interest rates can also be onerous. As of 01 December 2006 interest rates on credit card purchases amounted to 2 – 2.5% *per month* while those on credit card cash advances were set at 2 – 3% *per month.*

One would consider it morally wrong of banks to offer credit cards to young people who are still students in universities and do not yet have independent sources of income. They are also most vulnerable to the temptation to purchase consumer goods that they otherwise cannot afford, so there is a high probability of their encountering difficulties with paying their credit card bills in a timely fashion, thus being subjected to high interest rates.

Some alternatives to credit card usage that were not explored in the interviews are reliance on overdraft and personal loan facilities. An overdraft operates like a credit card whereby one draws on credit as one needs it, repays when one has funds, and it is a revolving facility, for which there is an initial charge upon its establishment and interest accrues on usage. Some individuals prefer the discipline of personal loans, which require regular instalments of repayment for a limited period of time. However, both facilities are not as popular as credit cards because they require

[107] Hong Kong Legislature, "Money Lenders Ordinance - Chapter 163 Sections 24 and 25," (Hong Kong: 1997).

specific application, normally incur initial establishment charges, and attract immediate interest expense upon utilization.

Ranking third in the number of cards issued and second in the level of outstanding receivables, Gorilla, which is a market leader in Hong Kong, considers this line of business a small profit contributor. Cards are granted on the basis of a credit scoring formula assessing the applicants and positive input from an independent credit bureau. In terms of personal profile, its credit card customers are better-established, middle-aged individuals who would typically be attracted to this particular bank.[108] This probably explains the comment that credit cards only provide small profits, because well-established credit cardholders are more likely to be transactors who pay off their entire bills on statement due dates.

The chief executive of Gorilla commented that people in Hong Kong were more inclined to save rather than spend by availing of credit card facilities or personal loans. Consequently he opined that there had not been any problems with credit card receivables except during the deflationary period of 1997 – 2003 when property prices collapsed 70% from their peak. During this difficult economic phase, people resorted to using their credit cards because they were unable to obtain other sources of financing. Many of these were unable to repay their obligations. A revision of the bankruptcy law, which allowed individuals to emerge from bankruptcy after four years, also caused some difficulties for the banking sector because this made it easier for individuals to declare themselves bankrupt, repudiate their debt, then after a short period of time be eligible for loans again. Despite these previous twin problems this banker opined that credit card delinquencies have reverted to a low level.

[108] Transcript HK 2. Code name = Gorilla.

Gorilla does not charge annual fees for credit cards except for the so-called black card, which is an elite card offering exclusive services such as a personal secretary who can arrange car rentals, theatre tickets, flight bookings and even private jet hire. Obviously those who require such services would not mind paying a fee.

Lion, which is one of the top two issuers of credit cards in Hong Kong and clearly a market leader, regards this an important and excellent line of business, contributing 20% of the bank's income. Lion's chief executive considers the local market developed and mature with sophisticated customers of a similar standard as those of the US, UK, and Europe, and therefore regards it as a fiercely competitive activity.[109] They operate in all market segments with different cards aimed at varying types. For instance, one card with a young flavour is targeted at the yuppie generation, others for the more mature individuals. In addition, they have diverse plans for transactors and revolvers.[110]

Even though the Lion banker was pleased with his bank's credit card business, he remarked that he would be worried if a bank anywhere became heavily reliant on it because he anticipated substantial changes in the business over the next few years. Hong Kong had a consumer credit bubble in 2000 – 2002 whose origins lay with individuals, who obtained multiple credit cards from numerous financial institutions (unbeknown to each other), amassed large charges and walked away from their obligations. This fiasco eventually led to the establishment of an independent credit bureau to keep track of credit facilities extended by financial institutions. This bank enforces tough credit standards particularly for unsecured loans and credit cards, so its loan losses are lower than the industry average.

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[109] Transcript HK 3.

[110] Transactors use credit cards for convenience and normally repay the full amounts outstanding when these fall due, while revolvers avail of the credit aspect and only make partial monthly repayments of the amounts outstanding.

Another banker from Dragon commented that Hong Kong has had a well-developed, mature, relatively finite market for credit cards for some time. Numerous credit cards have been issued, but the local credit card culture compares favourably with that in other Asian countries such as Korea or China where skills and techniques for identifying danger signs are less well developed and therefore potential problems might be concealed. In Hong Kong he believed that the customers are knowledgeable and credit cards are well understood, so when one takes a look at the incidence of bad debt in this segment, these are at manageable levels.[111]

This senior Dragon banker noted that local cardholders are less prone to avail of credit than individuals in the US or the UK, where carrying cash has long been unfashionable and reliance on credit facilities has been endemic. In contrast, savings continue to be a custom among Hong Kong families who by and large rebuff the advertisers' exhortations to splurge and charge luxury items and vacations to their credit cards and worry about repayment later.

A leading bank claims to have a very strong credit assessment approach that utilises historical inputs and sophisticated risk models to design application scorecards, which enables the institution to routinely underwrite a large volume of credit card applications and establish suitable credit limits based on an applicant's personal risk profile.[112] According to written comments this system relies on a comprehensive credit bureau that supplies up-to-date credit histories and outstanding loans from other financial institutions. However, in an interview, the Chairman of Dragon bank bemoaned the lack of positive inputs to the credit bureau, that is, only delinquencies and defaults are reported, not total facilities extended to all clients.[113]

[111] Transcript HK 4.
[112] Written response submitted on 27 October 2006.
[113] Transcript HK 9.

Thus it is possible for this system to inadequately verify an individual's credit capacity and therefore grant an excessive credit limit.

Nonetheless Dragon pursues a methodical approach of behavioural scoring to spot clients with a high risk of default based on their card usage. Despite any systemic deficiencies the bank also receives from the credit bureau a monthly update on all its credit card customers. Spending patterns are routinely tracked to detect customers with potential financial difficulties.

Defaulting customers are handled by Dragon's debt workout unit, which arranges debt restructuring for the customers. The bankers assert that the Dragon staff members behave sympathetically toward those with financial problems and that their priority is to maintain the client relationship. They consider this the optimum approach for amicably recovering their loans and preserving future opportunities to conduct business with the clients when they recover from their difficulties.

The top executives stated that their credit card business is sound even if it brings in relatively low income. The wide availability of cards has not altered the Hong Kong people's spending habits and, in the aftermath of the numerous crises that befell Hong Kong, individuals waited several months after the SARS epidemic was over before they resumed spending with credit cards. This seems to be evidence of growth in financial maturity of the population.

The proliferation of credit cards was due to competition and, according to some observers, possibly good for cardholders who obtain rebates and are able to earn awards with their usage, but the worry is the potential reckless issuance of cards to individuals who are not in a position to borrow or service their liabilities, for instance students. The bank regulator's concern is that all banks conduct business prudently so that it does not have to intervene.[114] Since non-bank institutions that are not covered by banking regulations also issue credit cards, the regulator normally prefers to allow the market to instil discipline. Its main anxiety concerns risk management, namely, that banks are issuing credit cards to the right people.

Hong Kong has witnessed scores of problems that surfaced during the period of economic crises and the devastating SARS epidemic. In the worst case scenarios credit card borrowers amassed debt exceeding 40 times their net income, leading to an extraordinary bankruptcy rate. The banking regulator identified the need for sharing credit information so that every lender could be aware of the overall level of indebtedness of each potential borrower or credit card applicant. The banking supervisor wished to ensure that banks take prudent risk and therefore encouraged the establishment of a credit bureau, which would be owned by the private sector. Since then, loan losses have dropped to comfortable levels. Credit cards remain a profitable source of income for the entire banking system but not a big part of overall earnings. This suggests that people in the community use credit cards more for convenience than to obtain debt.

In Australia it was reported in 2006 that the average household debt was comprised of housing loans (85%), credit cards (5%), and others, such as car loans (10%). This implied that personal credit card loans were likewise small in proportion to total bank assets.[115] According to an industry spokesman the evidence indicated that the majority of cardholders used their cards responsibly; the defaults were higher than those for housing loans but still at a low level.

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[114] Transcript HK 5.
[115] Transcript AU 1.

Industry sources indicated there was a continuing attempt to improve lending standards. For instance, if a card holder was discovered to be a recipient of Commonwealth government welfare benefits, then the banks would not grant that individual any credit limit increase. As a consequence of more prudent credit processing, banks experienced reduced delinquencies, and charge-offs were stable at 5%. In addition, reports showed that cardholders were paying off more outstanding debt in the 12 months till November 2006 compared to the previous two to three years when they had been borrowing more on their cards. From the standpoint of banking profitability the most costly clients were considered those who actively used their cards but paid the full amount of their statements every month, although these were the clients who did not present loan loss problems to the banks.

In the opinion of a bank CEO, Australia is a mature market for credit cards similar to Hong Kong and more advanced than most other Asian economies. However he said it was difficult to obtain credit information, so problems arose when individuals got caught in a 'credit spiral' as a result of obtaining credit facilities out of proportion to their personal income. He cited the case of a woman in her mid-50's holding a senior clerical job, who had outstanding credit card loans of A$ 120,000 that she was unable to repay. A quarter of this amount was owed on cards that had been extended by banks, while three-quarters was attributable to cards from non-banking institutions. It was apparently easy to obtain credit cards even for those with poor credit histories.[116]

A senior retail banker at Kangaroo declared that they wrote off 2.5% (which was superior to the national average of 5%) of their credit card business against outstanding receivables, which explained why credit card interest rates were much

[116] Transcript AU 2.

higher than open market rates, namely that they had to factor in the loan losses on these unsecured loans. Nonetheless Australian bad debt experience with credit cards was much lower than in the US and the UK where the losses in 2006 averaged 4.5 - 6.5%.[117]

Although it has adopted a conservative approach to credit card approval, Kangaroo makes sure that the collection practices are appropriate and considerate towards delinquent clients. They are reviewing and refining their hardship policies, so that customers who encounter personal difficulties have the opportunity to phone the bank and explain their situation, which could be the effect of a job loss or the trauma of a divorce. The bank might then arrange a deferred payment plan inclusive of an interest holiday during that period. The Kangaroo senior banker clarified that the bank is concerned about its *reputation* and does not want to be perceived as unduly aggressive in chasing debtors, so it makes an effort to discern if customers are undergoing genuine hardship or simply trying to swindle the bank. Kangaroo claims to have a reasonable policy on cases of adversity.

This institution states that it has implemented a responsible lending policy as evidenced in their refraining from offering credit increases to customers who receive government welfare benefits or fixed wages. The bank likewise avoids placing people in situations where they could be at risk. For this reason it normally does not issue credit cards to individuals under the age of 25 but instead offers a Visa debit card. The assumption here is that most persons under that age are new in the work force and may not yet have regular, steady sources of income, so their capacity to incur debt is still limited. But there are obviously exceptions that the bank would consider.

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[117] Transcript AU 4.

The observation was made that the Australian credit bureau operates negatively in that lenders only report people who miss payments or default, although it keeps track of how many credit applications a person has made. However, the credit reports do not indicate how many loan facilities that person has obtained or how much credit is currently outstanding. Nor does the bureau advise if that person has fully repaid his debt and should therefore be considered a good credit risk.

In 2006 the total amount of credit card receivables in Australia stood at A$ 30 billion compared to A$ 700 billion of mortgage loans, so cards reflected only a small share of household debt, though banks complained that problems in this sector attracted unduly harsh publicity in the press.

A respected former chief executive of a major bank asserted that he did not like the credit card structure and considered it a bad business practice. He found the fees acceptable but the interest rates inexcusable because the bad debt write-offs and fraud levels were being funded by an interest margin that he regarded much too high. Although it is a profitable business, he felt that it is pushed too hard.[118] This is precisely the ethical argument one should have against excessive credit card interest rates.

This retired CEO deduced that there is a section of the community that was prepared to pay high interest rates for what was basically an unsecured loan, which he assumed was probably cheaper than pawnshop loans. He cited other markets such as Japan where the ability of individuals at the lower end to access credit was very limited other than through loan sharks operated by criminal elements, and he regarded such financial hardships as much greater. This former CEO deems credit cards a great convenience and marvellous insurance in case one needs money while travelling

[118] Transcript AU 6.

overseas, and he always pays the full amount when due, which he considers the right way to use credit cards. In other words, one would describe his ethical view of credit cards as utilitarian in providing tangible utilities, though the major benefits accrue to cardholders like him who are not beguiled by the temptation to pay only a miniscule minimum monthly amount. Otherwise he believes that cards are not a good means to borrow money. In contrast to the current prevalence of features such as frequent flyer or loyalty points, he expects a simplified credit card structure will be offered in the future as a 'plain vanilla' option with competitive interest rates.

The former Kangaroo chief executive remarked that banking has been transformed from being highly restricted and regulated in terms of who could gain access to financing where there was no marketing involved, interest rates were set by the Reserve Bank, and directional lending was norm, that is, banks were guided in how they should lend money. According to this banker, social inequalities and problems abounded in the controlled regime, such as the limitation on loans to women, whereas today there is supposedly egalitarianism and equal opportunity with genuine freedom of access to money. But concomitant with that, one can get into trouble. As the former CEO said: "*People might behave unwisely and get carried away when credit is readily available.*"[119] While such comments from this banker ostensibly supports individual freedom, it also bespeaks an attitude that people are accountable for the consequences of their own actions and banks cannot prevent individuals from entering into potentially difficult borrowing situations. An objective commentator might depict this laissez-faire mindset as ethically deficient because there is scant regard for harsh consequences that befall hapless people.

[119] Ibid.

Another bank has adopted the responsible practice of not extending credit to those with a poor credit history and likewise does not increase pre-Christmas credit limits for those with repayment deficiency. In approving credit cards they look at factors such as education, financial literacy, in addition to income. The bank tries to ensure that the credit cards are appropriately tailored to the customers and the risks are well disclosed so that those risks for cardholders are minimized. One would view this as the correct approach for issuers of credit cards. In response to a comment that good customers subsidize the delinquent ones because they have to pay the same high interest rates as less creditworthy cardholders when they rollover their outstanding credit, a banker said that they were looking at a pilot project wherein there would be differential rates and products for varied customers and pricing would depend on risk.[120]

A compliance manager at Bilby, a very large non-bank lender, said that they have similar criteria as banks in approving credit card applications.[121] They maintain that they stress *responsible lending* in their agenda, whereby they carefully assess risk and the capacity to repay. Bilby believes that *it is not in its interest to lend to people who cannot repay their debt, because the firm would lose money.* The company has products tailored to suit a broad range of customers whereas it views the banks as having products that are characterized as 'one size fits all.'

The manager explained that Bilby offers risk-based products, which means that the more risk it assumes, the higher the rate. Yet he claimed that its lowest rate for personal loans is the lowest among all sixteen major Australian lenders. Its motor solutions activity is the second largest personal financing for cars, motorbikes, trucks, and jet skis.

[120] Transcript AU 10.
[121] Transcript AU 11. Code name = Bilby.

Bilby's retail finance activities include interest-free instalment purchases or buy now - pay later plans through retail merchants. It also offers credit cards through department stores; depending on the type selected, these supposedly encompass the lowest rate in the country as well as some of the highest rates. In distinguishing between *revolvers* (those who regularly roll over the outstanding amount) and *transactors* (those who pay the full amount outstanding every statement period), it finds that low rates are attractive to revolvers while interest rates are less important to transactors, who look for other features such as interest-free store finance on consumer durable goods.

This executive said that consumers should be more concerned with the true cost of making a purchase in order to determine the true cost of finance. Bilby claims to be proud of having driven competition in the market place so that big providers offer more choices and better prices. This firm is actually unique in having commenced as a finance company supporting department store sales or as a factoring company, which later started offering credit cards in the name of the department store and would then acquire the receivables of the store. This original role would seem to be an appropriate one for credit cards. It provides convenience as well as related financing to shoppers, while the vendors are able to monitor customers' preferences and adjust to them.

According to the Bilby manager, many individuals do not meet the lending criteria of major banks due to a variety of reasons: no regular income, self-employed with no steady wages, black marks as a result of missed loan repayments, negative credit scores. Examples might include recent widows who were dependent on spouses taking care of the bills, people who lost their jobs, individuals traumatized by severe illness or divorce. *Such a black mark remains on a person's record for five* *years.* This non-bank lender *would accept these sub-prime clients and probably offer higher rates on credit cards because of the additional risk.* But the sub-prime customers enjoy the convenience of credit cards as well as a 55-day interest-free period. After 5 years they can apply for a regular credit card with a lower interest rate.

Although Bilby and its Australian subsidiary, Currawong, gained a reputation as providers of sub-prime loans, this non-bank institution asserted that more than 80% of its clients belonged to the prime category. Loans written off in the prime class were alleged to be low and amounted to less than 1%, while it was a little more (undisclosed) in the sub-prime category.

Quoll's approach, which is predicated on defining its target audience as the members of its institutional shareholders, stipulates that its products must be simple, transparent, and equitable.[122] Hence there is no complexity or contingency in the product offering. There are no affinity programmes, no introductory offers, and no free balance transfer propositions. Instead what it offers are low interest rate cards oriented towards its constituency, who are primarily revolvers, that is, individual clients who do not repay the full amount of their monthly statements. These are intended to be fair deals and good value for working-class Australians.

Applications, which are available to everyone (whether or not members of the institutional shareholders), are processed through credit scoring of various factors such as disposable income, outstanding debt, overall risk of default, and credit references. The applicant must be a permanent resident of Australia, at least 17 years of age, earn at least A$ 25,000 yearly, and be able to repay at least 3% of each statement amount. Although Quoll admits to issuing credit cards to young

[122] Transcript AU 12.

individuals, it does utilise a means test and the members of its institutional shareholders include young workers who have recently completed schooling. The credit limits on the basic card range from A$ 1,000 to A$15,000; after nine months with a history of repayment the cardholder can apply for an increase of the credit limit. The bank declares that it has a conservative credit process relative to the market.

One institution, which values its role in its numerous communities as an important commitment, regards credit cards as a mode of convenience for individual clients. Most of its cardholders repay the amounts outstanding in their accounts on time, and only 20% are revolvers, who repay a minimal sum and roll over the balance. The bank proper as well as its community branches have a large personal instalment loan portfolio, and the proportions in arrears and in default are very low – less than the industry average. In the opinion of the Chief Executive this is the outcome of their screening process, which tries to make sure that people can service their obligations without incurring hardship.

Several attributes emerge in the review of the credit card business. Firstly, there is intense and widespread competition for market share among all the financial institutions, so that they offer a broad range of products with varying features. Some cards provide lower interest rates, which are targeted at revolvers; others have high rates but enable one to earn points with other partners such as airline frequent flyer groups; in Hong Kong they waive annual fees in order to attract users. This wide variety could actually make it more difficult for many applicants to choose the right product for their needs. Many institutions actively solicit credit card applications from young people who could still be students and may not yet be ready to manage their debt in a disciplined manner. Secondly, the credit approval is essentially an automated process that relies on a scoring system and cursory checking with a credit bureau, whose records only consist of negative reports; one should not infer that the credit is sound in the absence of negative comments. Such a system could result in the approval of higher credit limits than warranted. Thirdly, the proportion of cardholders who regularly rollover their credit each month pay an exorbitant interest rate on their loans outstanding because the interest rate pricing on credit card loans incorporates losses on defaults by non-creditworthy customers. The financially reliable are therefore being penalized for the excesses and non-payment of others. The fundamental problem is that there is too much pressure on salespeople at financial institutions to sell these credit cards.

C. Housing Mortgage Loans

This is a highly significant banking product, firstly, because all people require a shelter and most of them have conceived dreams of owning their own homes, so consequently a mortgage loan would be the largest component of household debt, and, secondly, because the aggregate mortgage loans would likewise constitute the biggest segment of the banking sector's assets. Individuals seeking to buy homes must go to a bank or other lender to secure financing, and the terms thereof impact on their savings capability and their quality of life. Even those who choose to rent their abodes are also affected because the property owners would usually pass on their actual or imputed cost of borrowing to the residents or lessees.

In Hong Kong mortgage loans constitute a large portion of the loan portfolio of the banking sector as a whole, so the banking supervisor has issued lending guidelines of a loan value ratio (LVR) of 70% and a debt service ratio of 50%, which was the practice at the leading banks 20 years ago and was viewed by the regulator as prudent and therefore adopted as guidelines.[123] Most of the banks observe these as standard procedures, thus contributing to sound mortgage assets.

Hong Kong has a remarkable history of housing mortgage loans because of the extreme fluctuations the economy has suffered. A property bubble preceded the period of deflation when property prices crumpled 70% from its pinnacle to its nadir, causing the negative equity of mortgage loans held by all the banks to exceed 30% and prompting concern from overseas banking regulators, who were monitoring the activities of Hong Kong subsidiaries under their jurisdiction. However, the sentiment of local bankers was that, so long as repayment delinquencies and loan charge-offs by banks remained low, conditions would improve over time and there was no need to worry.[124] Although there were purportedly slightly more delinquencies than normal, these remained low especially when compared to other countries such as the U.S. and the UK. When interest rates rose to high levels and people had financial difficulties, defaults were higher than normal. Nevertheless banks were convinced that the last thing that individuals would repudiate were their mortgage loans. Rather than forcing borrowers to sell their properties into a falling market, banks took a pragmatic attitude and lengthened repayment periods and reduced the amounts payable. Thus a potentially difficult situation was averted, and default rates these days are very low.

Compared with the peak of 106,000 cases of residential mortgage loans in negative equity at the end of June 2003, the number had fallen by 92% to 8,800 cases

[123] Transcript HK 5.
[124] Transcript HK 2.

by the end of September 2006.[125] The sector's overall negative equity had significantly improved to a level of 2%.

Property prices reached their height just prior to the Asian financial crisis of 1997, which was caused by overblown current account deficits of most of the Asian countries, including the so-called *tigers,* a term referring then to the rapid-growth economies of Korea, Singapore, Malaysia, but affecting all the countries in the region and instigating drastic local currency devaluation vis-à-vis the US dollar and severe economic slowdown across the entire continent. By that time the Hong Kong dollar was pegged to the US dollar, so there was no devaluation as such, but the crisis and the handover of the territory back to China that year precipitated a massive sale of residential properties.

On the heels of the financial crisis, which lasted a few years, came the consumer credit bubble in 2000 – 2002, then the dreaded SARS epidemic in 2003. Property prices therefore did not begin their recovery till 2004, which continued in the succeeding years. Residential unit prices in 2006 were almost at the same level they had reached at their peak in 1997.

Housing prices are driven by the forces of supply and demand, which were greatly swayed by the above-cited calamities. Some banks concentrated on financing upper-end or luxury housing, which was more sensitive to the fluctuations of demand and supply. At this level many people bought properties not only for their own residence but also additional ones for investment and speculation. And this was not confined to the local scene; the Chinese in Hong Kong and the mainland had a voracious appetite for properties in Hong Kong, London, New York, Sydney and Melbourne. They have long considered real estate as a major hedge against inflation.

[125] HKMA, Press Release, 6 November 2006.

Due to the investment demand and its relatively limited supply, luxury housing was the first to recover. The continuance of Hong Kong as a major global financial centre has also been accompanied by the steady influx of expatriate investment bankers, financial advisors, and specialists in allied professions.

Comments made in the interviews indicate that banks in general treat housing loan applicants the same way whether they want to purchase a unit for their own dwelling or as an investment. They are only interested in the borrower's capacity to repay the loan.[126] Bankers disagree with the suggestion that they have encouraged property speculation by providing easy credit because in their view the principal banks have always maintained strict credit policies and procedures. Certain bankers argue that, even in the absence of Hong Kong Monetary Authority (HKMA) guidelines on housing loans, their banks would still call for a loan to value ratio of 70% and debt service ratio of 50%, because this is deemed to be good banking.

Instead of a loosening of credit standards, the interviewees claimed that intense competition for housing loans resulted in improved terms and conditions for borrowers. As an example, the typical housing loan in 1973 carried an interest rate of BLR[127]+ 1.75% and a tenor of 7 years, while the average terms in 2006 were BLR - 3% and a tenor of 20 years.[128] The interest rate dropped by 475 basis points[129] and the final maturity lengthened, thus benefiting the customers. The total housing loan market has grown substantially but the banks earn less, though the assets continue to be of high quality. At the end of 2006 the 3-month delinquency rate was 0.20% while this bank experienced 0.19% and a charge-off level of 0.03%, which were described

[126] Transcript HK 3.
[127] Best Lending Rate, which is called prime rate in some countries, is the interest charged by the Hong Kong Monetary Authority to its licensed banks through its discount window.
[128] Transcript HK 2.
[129] A basis point is equivalent to a hundredth of 1%.

as very low by world standards. This demonstrates that banks can maintain profitability and preserve the quality of its loan assets thus contributing to banking stability, while satisfying the needs of individual customers. The approach of the banks in Hong Kong to improve rates for customers rather than sacrifice lending standards in the face of competition appears to be driven by motivation stemming from virtue ethics. One should therefore contrast this attitude with that embraced by the American sub-prime lenders who chose to relax credit norms in order to generate more business.

A leading bank asserted that it operates on the premise that human beings "always have a need to buy houses as they grow older, as they get married, or simply to improve the present living condition." Therefore the group offers "first class mortgage financing support to help people fulfil their dream of home-ownership."[130]

The bank adheres to prudent mortgage lending policies[131] while remaining competitive with the best deals and product choices available to the customers, who are encouraged to spend time discussing their financial needs with the bank staff. When the clients encounter unforeseen difficulties in meeting their obligations, the bank advises them in finding appropriate solutions. The debt workout unit provides assistance to defaulting customers that can include debt restructuring.

One can draw a number of conclusions from this fascinating narrative on housing mortgage loans in Hong Kong. The first is that catastrophes can occur in a terribly major way from wholly unexpected sources, and most of these are unavoidable despite what a few critics might claim in hindsight. Secondly, banks that espouse ethical values observe prudential practices, which include sound risk

[130] Written submission by Dragon.
[131] Although the bank maintains a LVR of 70% for owner-occupied properties, it says it stipulates a LVR of 50-60% for investment properties.

management. Thirdly, the anecdotal evidence from numerous sources indicates a genuine concern and trust on the part of bankers towards their individual home loan customers. This concern manifested itself in the manner banks attempted to assist borrowers in difficulties that in turn resulted in minimal defaults and negligible home foreclosures.

A focus on the customer starts during the initial discussion when the bank representative must ascertain and understand the prospective borrower's needs and financial condition, then plainly and comprehensively clarify the features and risks of the mortgage loan options. Prudence would dictate recommending a loan that the borrower can comfortably service even in the event of unforeseen calamities, such as a financial crisis, higher interest rates, and loss of income.

In Australia access to housing loans has become easier for most would-be borrowers. A prospective homebuyer used to go to a bank, which would estimate the value of the property and assess the financial capability of the applicant in order to reach a decision on whether or not it would approve the loan request. Nowadays potential borrowers go to loan brokers, who take care of finding a financial institution willing to grant a loan with the optimum terms and conditions to suit the respective borrowers. These could be any combination of: the highest LVR (loan to value ratio) or the amount of the loan in proportion to the assessed value of the mortgaged property, the interest rate (fixed or floating), the term or final maturity of the loan, and fees.

A few institutions do not rely on brokers and evaluate each loan application on its merits and based on the creditworthiness of the borrower make decisions on the credit approval and the relevant terms and conditions. It appears that credit unions are more conservative lenders that are prepared to lose loan applicants who are dissatisfied with loan offers they receive.

Traditionally the LVR at Australian banks has been 80% but due to competition from non-bank loan institutions some lenders have considered an LVR of 95% with mortgage redemption insurance on the differential. Conservative banks still calculate the value of the property based on current market prices not on future inflationary expectations.

Lending practices changed in the decade until 2005 because asset prices had continuously risen. The Perth housing market in 2006 was still strong, though the Sydney market, which had experienced a boom followed by a slump, was still generally in a satisfactory condition.[132] But people's incomes did not keep pace with asset price increases, which meant that banks had to change the way they lend. Financial institutions developed inventive techniques to help people own homes, mostly through low or no documentation loans. These were provided by non-ADIs[133], which did not take deposits from the public and were therefore not regulated by APRA[134]. The typical borrower did not meet the credit standards of a bank and therefore would be described as a sub-prime customer.[135] Generally there were fewer documents and less verification of employment and income than in the case with bank loans.

Defaults were much higher among non-APRA-regulated lenders. Loans provided by APRA lenders that were 90 days in arrears amounted to 0.3% of total loans outstanding, while the comparable level at non-conforming lenders was 4.1%.[136]

[132] This refers to prevailing conditions in the latter part of 2006. Transcript AU 1.
[133] ADI refers to an Approved Deposit Taking Institution which is regulated by APRA.
[134] APRA refers to the Australian Prudential Regulation Authority.
[135] Similar to the sub-prime residential mortgage loans in the U.S.
[136] These are for the year 2005. Transcript AU 1.

These sub-prime lenders securitised their loans and sold them to investors unlike banks and APRA-supervised ADIs which relied on deposits and carried the loans on their balance sheets. Data for 2005 indicated that 3,800 individuals in New South Wales and the Australian Capital Territory lost their personal homes (excluding investment properties) due to foreclosures. Of these affected homes, non-banks had financed 80%.

Some interviewees observed that the mortgage loan market had changed over the past several years due to several factors:[137]

1. The emergence of non-bank lenders active in the sub-prime market. These lenders were aggressive because they were backed by securitised funding vehicles and did not raise funds through deposits from the public.[138] These provided loans to individuals with impaired credit and usually at higher loan to value ratios.
2. Some banks started lending at 100% or more of market values. Their rationale was that the investment strategy of a client with sufficient equity available was usually predisposed not to deploy that equity into a property purchase. Investment properties became the most favoured form of investment assets in Australia because of the significant tax advantages of negative gearing. The accelerated depreciation of capital assets combined with interest deductions provided the investor borrower with negative tax positions while the value of the property was rising. Most financial planners advised customers to include an investment property element in their portfolios.

[137] Transcripts AU 4, 6.
[138] As seen earlier, this keeps them off the radar screen of APRA.

Though high LVR loans might be defensible because of the tax effective nature of investment planning, there were worries that of some of these loans had been extended to individuals who were financially too stretched to be able to buy properties, and this was an inappropriate market segment to pursue. The financial press in 2006 reported the rising level of personal debt in relation to income and the diagnosis of a property bubble, but some bankers in the research study subscribed to the view that analysts were looking at debt without examining the equity, namely that asset prices had escalated dramatically so that the borrowers' equity position remained strong.[139] These bankers were in denial of the dangers of ballooning personal indebtedness.

The dynamic[140] LVR across the mortgage loan portfolio of Kangaroo bank stood at an average of 68% implying an average equity ratio of 32%.[141] This bank did not see any problems in its group because of its professed conservative lending practices though it recognized problems in the industry. In this case the bank tried to make sure the monthly mortgage payment was no more than 10 – 12% of the borrower's unencumbered monthly income. Furthermore the borrower's available income had to be able to absorb an increase of 1.5% (150 basis points) in interest rates. Kangaroo thus did not want to lend 100% of property values and wanted the customers to be well protected.

Reverse mortgage loans at some institutions were increasing. These were loans granted on properties whose mortgages had been repaid. They were generally

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139 This is precisely what a property bubble means; as prices increase, homeowners have the illusion that they are becoming wealthier, but property prices do fall.
140 This means that the ratio is adjusted as the denominator, i.e. the market values rise, so it is a moving ratio and therefore a potentially unreliable one because it ignores price volatility.
141 Transcript AU 4.

offered to older persons (approaching, or in, retirement), who then owned their homes and wished to liquefy the monetary value of their properties.

The more conservative banks did not provide reverse mortgage financing because they were concerned about their reputation. If someone had put his life savings into his home, which was his primary source of wealth (the typical situation for most Australians), how would it be ethical to force him to sell his home later in life to service a loan?[142]

Some bankers recognize that there are legitimate customer needs for such a product but the problem arises when unscrupulous financial firms take advantage of innocent customers who are not financially sophisticated. One bank was considering experimenting with a "good product that guarantees a reasonable proposition for the customer."[143]

Reports in Australia indicate that only a small number of people in actual fact have lost their homes. In default situations the collection units at banks try to arrange refinancing. Banks claim that they truly wish to avoid having to throw somebody out on the street. The reputational damage for them is very high.

When banks offer reverse mortgages, their rationale is the potential need for people to obtain cash from the equity in their homes. This is the situation of so-called baby-boomers, who have worked all their lives and possess assets, yet are often cash poor because they might have retired, but have an increasing need for medicine and supervised care as they grow older. They could either sell their homes and move to smaller flats or re-mortgage their property to achieve liquidity.

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[142] Transcript AU 2.
[143] Transcript AU 4.

This is in contrast with the indebtedness of young professionals who are availing of current loans secured by their homes and splurging on luxury goods. This is a well-established product that is popular with professionals but is dangerous and requires a clear appreciation of the potential risks. It needs good personal understanding of the borrowers by the bankers, but face-to-face contact has been replaced by scorecard formulas. In an effort to keep costs down, loan applicants are asked to fill in forms and are rated on score sheets. If applicants fit the desired credit risk profile, their credit requests are granted. There is no interpersonal contact and therefore no attempt to understand the individuals.

There is a mindset among bankers that banks must satisfy clients and generate profits. A bank would not be in business long if it did not satisfy its clients or make profits.[144] But many admit that bank products are very complex. The opinion in several banks is that the fee structure could be complex although actual interest rates might be quite competitive. Some bankers feel that fees and interest rates are not too difficult for most people to comprehend. The retired Kangaroo chief executive argued that if someone borrows money, he should be able to cope with the relevant concepts or otherwise he should not be borrowing. The CEO did not accept that ethical issues are involved because he did not think any bank was trying to deceive anyone.[145] From this banker's perspective the policing of advertising conduct was pretty strict.[146]

[144] Transcript AU 5.
[145] Ibid.
[146] Transcript AU 6. However a newspaper reported in mid-2006 that a major bank was forced to withdraw its advertisement for a deposit product because this was judged to be misleading. The product entailed a savings account that paid higher interest but one could not make normal payments from this account and needed to transfer funds to a separate operating account; the ad did not clearly indicate that the operating account required a distinct minimum balance below which a fee was charged.

This traditional banker bemoaned the change of culture that has meant the *loss of fiduciary responsibility.* He explained his view:

> It used to be that banks were obliged to make sure that it was prudent to lend and that the borrowers had the capacity to repay. Now banks just want to lend the money out provided there is adequate collateral and get it repaid when due, so now there is mortgage insurance. The focus is on repayment and recovery of the loan, not on the hardship or the practicality of the individual being able to service the debt. Bankers have become straight commercial people; they do not have the obligation that went with fiduciary responsibility.[147]

These are harsh words coming from a former chief executive of a large bank, whose current senior executives speak of a new culture of customer-focused service. Although he insisted that he was expressing his personal views rather than those of his former institution, one presumes that he maintains contact with bank officers and certainly keeps up with developments in the industry. One might construe this as an elucidation of the actual prevailing *frame of mind* in contrast to the discourse used by the banks that profess to have values and the readiness to contribute to the community.

This customary belief is that banks lend 80 to 85% of the value of properties and obtain mortgage insurance for the balance so the loan component does not actually assume the full risk of recovery. They regard a mortgage as an amalgam of three elements:[148]

1. availability of money
2. administrative system keeping track of repayments and outstanding balances

[147] Transcript AU 6.
[148] Ibid.

3. sales: mortgage brokers who are not involved in the first two elements but function like commission salesmen trying to find the best deal for the clients; their role is similar to those salesmen of unit trusts.

The sales-oriented structure briefly described above probably accounts for the majority of mortgage loans. In the event of default one method of debt recovery is foreclosure of assets. One reason banking works is that there are clear property rights that can be assigned as security and enforced. When the property in question is somebody's home, it would be prudent to limit the amount of the loan in order to minimize potential strain on the borrower's capacity to repay and avoid foreclosure.

When the former bank head was queried about the danger of a property bubble, he recounted the episode of the 1980s that witnessed a boom period with growth fuelled by banks. According to him, the ultimate cause of the boom was the deregulation of the Australian dollar that triggered a flood of overseas funds coming into Australia. He believes that the problem was that the Reserve Bank was not carefully monitoring the money supply growth that soared to an annual rate of 20%, which after five years could only be inflationary. The banks were lending out money aggressively, purportedly in order to protect market share, and this drove up the stock markets, followed by property.[149] This retired CEO explained that bankers were unfamiliar with a situation lacking foreign exchange controls, so this period was a disaster especially for the state-owned banks, many of which collapsed under the weight of bad loans and were taken over by other banks.

Although the situation in the 21st century may have different underlying factors, there was no doubt that property prices had been escalating rapidly in the ten

[149] Ibid.

years till 2006 and financial institutions were instrumental in providing housing mortgage loans, which fuelled the demand for property.

This research project showed that the mortgage loans of Bilby, the large non-bank lender,[150] were all originated through brokers, although Currawong, the subsidiary it acquired a few years ago, marketed its own home loans directly. The principal firm targeted the so-called *'non-conforming market',* typically, self-employed individuals who are unable to provide much documentation to support their loan application; these are similar to the sub-prime market in America. The Currawong subsidiary claimed to have the lowest mortgage rates in the country. The entire group offered a wide variety of mortgage loans with diverse features and degrees of flexibility.

The Bilby group did not grant reverse mortgages but was then considering doing so despite ethical concerns. At the time of the research they were offering an unusual 40-year mortgage whereby individuals were able to buy properties that would otherwise be unaffordable for them. The underlying assumption was that over 40 years the value of properties would rise so that repayments would become easier.

The Bilby executive claimed that media reports about foreclosure of homes were mainly incorrect. He asserted that they and the banks *bend over backwards to make sure that people are not evicted from their homes, which is the last thing they want to happen from both an ethical and financial point of view.* He maintained that financial institutions lose money when people are thrown out of their houses.

The company contends that it assesses the individuals' repayment capacity but circumstances change and, when difficulties arise, they still try to accommodate the

[150] Transcript AU 11.

customer as well as they can. Several cases were cited. The executive stated that in genuine hardship situations they would write off debt. Bilby and Currawong pursue the collection of their own debt for 100 days after which they sell the loans to collection agencies. There are allegedly tight regulations covering collection agents.

The medium-sized bank Quoll provides mortgage finance up to a maximum of 90% of the property valuation and requires mortgage insurance, while many other institutions lend 95 – 100% and some up to 105% LVR. For this bank *responsible credit management is important* and they do not want people overly geared. As a consequence they have *a default rate in housing loans of only 25% of the industry average.* This is a striking difference.[151]

Anyone can establish an account relationship at this bank, but *members* of the stakeholders, which are employee unions and superannuation funds, receive a discount of 25 basis points from the standard rate on housing loans. Otherwise the interest rates on all products apply equitably for everybody whether they have low incomes or high net worth, and there is no discrimination based on income or job position. The bank does not seek to offset the risk of low-income borrowers or reward high-income earners.

This institution, Quoll, which had been an originator of home loans since 1994, received its banking license in 2001. It continues to originate its own mortgage loans, though it has a separately branded product with a small share of the overall business that is distributed through mortgage brokers. Late payments do occur, but there is a communications programme whereby Quoll contacts late payers to ascertain the reasons. When debtors default, the collections department treats all customers in

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[151] Transcript AU 12.

the same manner, encourages communications, and assists them in repaying their debt.

In an environment where interest rates have been historically low, home loan affordability has been very high. The asset price increase has been significant, as people have borrowed much more. This price rise has been due to an excess of demand over supply. It is the view of many senior bankers that lenders are not at fault because this situation is supposedly due to state and local government planning of land release. The opinion of bankers is that government entities have released inadequate housing stock to meet increased demand arising from population growth.

The asset portfolio of the former building society that converted into a bank has a large segment of residential mortgage loans: 75% of the portfolio in terms of security valuation and 67% in terms of purpose. The former includes loans secured by home mortgages but taken out for personal investments and for commercial purposes. The average loan valuation ratio (LVR) of the entire portfolio is 50% because there have been repayments on the loans outstanding, while the LVR for new housing loans is generally below 70%. Where mortgage insurance is provided, the bank may lend up to 80% LVR. Because of this prudent approach there is a very low rate of repossession.[152]

Quoll offers reverse mortgage credit as short and medium term financing up to 5 years. On the other hand, the community bank approaches reverse mortgage finance in the form of equity access finance whereby the bank becomes a part owner of the property.

[152] Written response.

To summarize this section, the expectation in all modern societies is for people to have dwellings in which to live and the common objective of many individuals is to own their own home. Those who choose not to buy their abodes would nevertheless have to rent from other people who own these properties. In every instance the residential accommodation would need to be financed by a bank or another form of lending institution. Because housing mortgage loans are normally the largest debt obligations that individuals will ever undertake in their lifetime and they require exceptionally lengthy periods and substantial sums of money to repay, it is ethically incumbent on mortgage lenders to fully appreciate the personal circumstances of prospective borrowers and provide comprehensive advice on possible risks. The research indicates that certain banks do this but many others are more interested in closing a sale and making a housing loan without much consideration for what happens to the customer after the loan has been released. Dur to competitive pressure numerous lenders have quite often granted loans in amounts equal to, or in excess of, the purchase prices of the properties with inadequate examination of the impact of repayment on the borrowers.

As Chapter 6 will illustrate about the sub-prime housing loan market, this behaviour on the part of some mortgage lenders, which has arisen from a lack of ethical values, would prove to be the catalyst for the implosion of the entire global financial system.

D. Corporate Finance

On the one hand, banks attempt to look after the requirements of individuals through their retail or consumer finance departments and perhaps millions of physical branches and automated teller machines as well as online services. On the other hand, they provide specialised tailor-made corporate finance to the large and medium sized companies. The ethical considerations here relate to how the banks strive to fully comprehend these commercial customers, the purposes of the loans, and the sources of repayment. Because all corporations have financial officers specifically tasked with banking relations, this segment of the research does not focus on how banks relate to clients but rather how they reveal their values during the interactive process with corporations.

Since nearly all corporations employ several layers of knowledgeable and highly-trained financial and legal specialists, the concern is not about corporate clients receiving unethical treatment at the hands of banks but rather the instances of conflicts of interest and corrupt practices on the part of banks and their employees while the deeper focus is on whether banks acquiesce in the perpetration of unethical practices by corporate clients.

Several banks affirm that all their staff members are required to undergo sessions on the ethical values embodied in the respective Bank's Code of Conduct; the stress seems to be the recognition and avoidance of conflicts of interest throughout the process of credit policy formulation, marketing, credit proposal, independent review and approval. These banks state that they strike a balance between foreseeable social costs and anticipated business opportunities and that they are prepared to give up the latter if they come at the expense of their commitment to social responsibility.

According to some bank managers in Hong Kong their credit policy follows the best practices on environmental risk management as released by the Hong Kong

Association of Banks. They maintain a list of industries considered high risk for ethical reasons. For instance, some banks do not finance gambling casinos.

In addition to evaluating the *credit risk* of financing proposals, a few bankers stressed the importance of assessing *reputation risk,* meaning that they would not wish to be involved in any activities that would damage their reputation. Since a handful of them have adopted the Equator Principles, these banks ensure that all projects that they support are environmentally sustainable. They would turn down loan requests for projects that damage the environment.

The chief executive of Lion Bank affirmed that his bank's relationship managers[153] are very well trained and among the best in the industry. These managers are expected to regularly visit the customers' premises, be thoroughly familiar with all operational facets, and fully understand the lending rationale in each situation. Through managing a good relationship process, the bank puts robust credit evaluation into practice and, as a result, has experienced a low level of loan losses.

Lion Bank is selective with the industries to which it provides financing. As a principle it will only finance those in which it has banking officers with specialized expertise. For example, it previously shunned the electronics and airline industries but now lends to them because they have acquired the requisite industry know-how through recently hired banking professionals. The bank finances projects in China both from Hong Kong and its affiliates on the mainland. It does not support subterranean mining operations due to a lack of industry competence, though it grants banking facilities for extraction activities above ground.

[153] These are corporate banking officers who look after the financial requirements of designated companies within specific industries. Transcript HK 3.

Lion has undergone rapid growth in corporate finance over the last five years and is now a major player. The CEO's remarks depict an institution that has developed and implemented prudent credit policies and procedures, which are vital for a sound bank and a stable monetary system. However, there is no explicit reference to ethical values relating to conservation of the environment or upholding of social values in the community. Lion states that it refrains from financing gambling casinos but admits that the bank is a big lender to property developers and hotels, which might lease out a small portion of the premises to casinos. In such cases the chief executive claims that the bank would carefully weigh up the overall merits of the project.

Dragon, another large bank in Hong Kong, stated that it has long-standing guidelines about companies to whom it will lend and with whom it will invest.. The bank expects its customers to comply with the relevant legal and regulatory requirements wherever they are doing business. Dragon also tends to take a decidedly public stance on such issues. It was one of the original signatories of the UN Environment Programme Statement by Financial Institutions and a member of the UN's Global Compact, which challenges companies to advance labour standards, human rights and environmental responsibilities. Dragon has endorsed the Global Sullivan Principles that address economic, social and political justice issues. It supports the OECD Guidelines, which promote sustainability, and has also adopted the Equator Principles, which requires assessing the social and environmental impact of long-term commercial lending.[154]

As a consequence these Dragon bankers declare that they are even prepared to walk away from business with existing customers if these fail to demonstrate ethical

[154] Written response from Dragon on 27 October 2006.

behaviour with respect to the environment and communities in which they operate. They cited as an example that they have traditionally been major bankers for the timber industry in Malaysia but now will only finance those companies that practise sustainability through replanting of trees. A further comment was that Dragon had not provided banking services to entities engaged in the manufacturing of armaments and munitions for the last thirty years.

In shifting the focus to Australia, one sees diverse types of corporate finance because of the extensive range of company sizes and varieties of financial institutions. The credit unions, building societies, and community banks normally have a very small percentage of loan exposure to commercial finance, which would typically be in local agriculture, such as faming or fishery, tourism in the form of restaurants or small hotels, or other small business enterprises such as sundry retailers, handicrafts and specialty food producers. In these instances the banks should very likely be well informed about the plans, operations and progress of their various customers. While there might be exceptions, one would expect that accountable bankers would quickly discover if their clients were causing some harm to the community, engaging in fraudulent practices, or were themselves experiencing difficulties.

At the other extreme one finds major commercial (trading) and investment (merchant) banks[155] whose clients are large Australian or multinational corporations operating throughout the country and the whole world. As cited in the case of an international bank in Hong Kong, many large companies operate in industries that require specialized technical expertise on the part of the relationship banking managers. The industry sectors of greatest concern to responsible banks are forestry and mining. Banks that adhere to the Equator Principles extend only a modest

[155] In Australia commercial banks are called trading banks while investment banks are frequently referred to as merchant banks.

amount of financing to forestry projects and only consider old-growth forests while requiring the companies to adhere to strict Australian environmental regulations, which they deem more protective than in many Asian countries.

Mining is a big segment for some banks and therefore more difficult to ensure that environmental safeguards are in place. In evaluating loan requests they need to probe into the environmental policy of the corporations.[156] Banks claim to be generally satisfied with Australian entities operating locally but have concerns with overseas joint ventures because an overseas partner might take short cuts that are permitted in their own country but are in violation of sound environmental principles. Truly responsible banks stress that they believe and enforce their environmental policies and encourage their existing and prospective corporate clients to alter their environmental behaviour even if they might lose customers.

A handful of banks claim not to be active in financing leveraged buy-outs and compare this situation with the eighties when high-profile entrepreneurs borrowed large amounts of money in order to take over public companies. In a leveraged buy-out, the acquiring entity (A) assumes control of another company (B) by obtaining loans through a pledge of the assets of the acquired (B). In many cases the loans are repaid through greater profits attained through sales of the pledged assets and cost cutting from the phase-out of some operating divisions and termination of workers.

It is highly noteworthy that a former bank chief executive declared that corporate finance has changed. In his day there were still genuine corporate relationships where a major corporation, such as BHP, would have a lead bank that could extend a significant loan facility to it and would understand its operations and requirements. BHP would be able to rely on that bank and there would be mutual

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[156] Transcript AU 2.

assurance of trust and goodwill. Nowadays banks tend to sell down any big exposure so they have less risk from any single borrower on their balance sheet. They sell off the loans through *asset securitisation,* which is different from the process of *loan syndication* in which the lead bank maintained a relationship with the corporation.[157] In a syndicated transaction the lead bank would underwrite significant amounts of debt that it would subsequently parcel out to participating banks, but it would always retain a sizeable portion on its own books. Nowadays banks prefer to completely unload the entire debt offering, so banks are uncertain which bank is maintaining a credit watch on the debtor, and the former bank head said this should be a concern to regulators.

If this is indeed the case, then the banks might possibly be negligent in their continuing credit monitoring of the corporate borrowers and consequently ill-informed about their activities and how these impact on the community and environmental sustainability. However, when this retired banker was asked about his opinion on the Equator Principles, he expressed a firm conviction that banks should not impose their values on everybody else because their purpose is only to provide financial intermediation service.

He feels that it is acceptable for a bank to provide financing for a project that is a legitimate part of the community, if the bank's due diligence determines the ability of the borrower to repay the loan. If a project (such as a power plant that is a potential pollutant) or an enterprise (such as a logging company) is legally permissible in a state and its operations do not run the risk of foreclosure, this former Kangaroo chief executive says it is *not the bank's job to say that its values cannot support that.* This attitude essentially affirms that a bank must not develop its own

[157] Transcript AU 6.

set of independent ethical values. This way of thinking is reiterated by another banker.

An allied view in banking is that true corporate relationship lending has probably existed only in the middle market and has not been evident at the top end for some time. The reason is that major corporate entities have direct access to a wide variety of market instruments through investment banks and do not want relationships with commercial or trading banks. On the other hand, middle market companies have less choice in terms of capital market instruments so they require intermediaries and banks are still key providers of funds.[158] Therefore relationship plays a role and is critical to success for both borrowers and banks.

For small business enterprises it is not considered practical or affordable for banks to employ relationship managers for a company that has an A$ 50,000 loan, so no deep relationships are formed. In the past small business firms did not receive unsecured loans from banks and used to pledge fixed assets (property or equipment) in order to obtain loans. Small business has gained the most from deregulation, which has given such firms more access to intermediation.

The demise of relationship banking suggests that the major banks are no longer completely knowledgeable about the activities and operations of their largest borrowers and customers. The banks would necessarily be dependent on public disclosures of these corporations and supervision by government regulators. However, it indicates that banks are not fully aware of the ethical conduct of their customers.

[158] Transcript AU 9.

Some senior bankers say that, while their banks cannot support a client in any illegal activity, they see a problem in traversing legal requirements to ethical criteria because *they do not want to impose their own principles on other people or companies. If a certain activity is legal and deemed acceptable by society, then they see no reason to deny banking services for that.*[159] An example of this line of thinking in some banks is a presupposition that society endorses the existence of gambling, so these institutions lend to every casino and gambling operator in Australia. The argument is that an organisation should not interpose its values beyond those of a democratic society. This is the outlook of some senior executives. There is a similar approach to environmental sustainability. While some banks do not support companies that damage the environment, they rely on governments to set the standards and enforce them. They consider banks a reflection of society and therefore reason that one must start with society, not banks, to identify its values. They contend that in a democratic system people elect a government to make decisions on their behalf, including passing legislation that reflects the mores and values of the society.

However bankers are pragmatists. Ultimately an institution will pursue its own interest. A senior banker at Kangaroo said that if a sizeable proportion of their customers close their accounts to protest the bank's loans to gambling operators, they would probably reconsider their position, because it might not be in the bank's economic interest to support gambling in the face of widespread opposition.[160] This is a statement of self-interest in the pursuit of profits.

In exploring the topic of lending in China where certain domestic companies have been reported to be guilty of environmental destruction, unsafe working

[159]Transcripts AU 6, 9.
[160]Transcript AU 9.

conditions, and manufacturing of consumer items deemed dangerous to the health[161], a top banker asserted that they conduct significant due diligence prior to undertaking any loans and investments. However he cautioned that they *must be careful not to introduce Australian or Western values and profess moral and economic superiority when judging the wisdom of the actions of Chinese enterprises.* This corporate banker believes that the Chinese do not consciously seek to pollute the environment but are still learning. The consequences only emerge slowly over time, so perceptions thus change and banks adapt rules to those new realities.[162]

The responsibility of banks operating globally is to convey the set of ethical values underpinning their policies to customers who operate in other geographical locations and at the same time to comprehend the differences in values of the other regions. Where minor disparity exists, the banks should engage with their customers in dialogue in order to reach acceptable consensus. If significant divergence presents itself, the banks should assert their values and insist on their acceptance as a pre-condition of establishing a banking relationship.

A senior banker at Bandicoot, a leading financial institution, explained that project financing in their group encompasses three sectors: energy and utilities, infrastructure, and resources (relatively small proportion compared to the rest).[163] Two senior engineers with significant experience at both practical and consulting levels review the environmental and engineering aspects of each project and report separately to the approval authorities on compliance with environmental regulations. The credit approval process goes beyond the economics of the transaction and

[161] In September 2008 a Chinese company was accused of manufacturing powder and liquid milk for infants that contained melamine, an ingredient used in producing plastics. As a result several babies had died and thousands more fell ill.
[162] Transcript AU 9.
[163] Transcript AU 14.

considers social issues and as well as the project's environmental impact. The bank's position is less complicated than at other firms because until recently it has only financed projects in OECD countries, which have stringent environmental protection schemes. These project lenders maintain that they try to form a view of the customer and not just a specific transaction; they normally receive the project deal flow from existing relationships within the bank.

At the time of the interview, Bandicoot was not a signatory to the original Equator Principles because, after discussing the matter with the International Finance Corporation and other banks, the project financiers contended that their standards were more rigorous. However, after looking at the new Equator Principles, the bank's so-called carbon solutions group began reviewing the bank's systems to determine if these were sufficient to be able to adhere to their avowed corporate principles. Carbon trading in Australia was said to be limited because the country was not a signatory to the Kyoto Protocol on the environment.

Bandicoot participates in private equity and leveraged buyout deals and disagrees with the contention that jobs are often eliminated in order to prop up earnings. The counter-claim here is that the bank generally looks at private equity propositions in situations of underperforming companies wherein injection of capital expenditure leads to increased productivity. One could accept that infusion of private equity to improve performance and management efficiency is a fine business model but most cases are accompanied by substantial leverage with the target company's assets utilised as collateral for huge debt piled on the company. In order to service the added debt the company needs to cut other costs, which usually include manpower.

There are several observations on how bankers see their activities in corporate finance. Firstly, there seems to be the aspiration among some key banks to fully understand the operations of their customers through recruitment of industry specialists, who are able to analyse industry-specific project and credit risks. The risks also include possible harm to communities and the environment. These analysts assess the likelihood of project failure and corporate inability to achieve set targets, and they attempt to devise mechanisms to mitigate against such risks. What is bothering is that some risks are not perceived in advance and, even if they are, the measures taken to prevent their occurrence could prove to be deficient.

Secondly, it is worrying to hear some senior bankers lament that relationship banking has ceased to exist, because this implies that banks no longer maintain ongoing dialogue with their key corporate customers and are not as well-versed in the execution of strategy, operational issues, and needs of these companies as they used to be. These circumstances have developed because of the dominance of investment banks which have promoted direct access to financial markets as global liquidity multiplied during the decade ending in 2007. Due to falling interest rates and growing investor appetite these institutions were eagerly competing with each other to win mandates from corporations wishing to raise debt or equity in the capital markets. The investment banks have previously only worried about market risk, that is, whether they could sell off the full amount of their underwriting. They have a short-term focus on the highly lucrative immediate fees from each transaction and the trading profits on the securities they handle, so they have no motivation to sustain a continuing credit review or ethical audit of these corporate clients. They are aware that, when these companies need to raise funds again in the future, the choice of lead investment bank will rest on the bank's performance in the previous fund raising and on the attractiveness of the future offer. The inference is that banks have relinquished accountability for the actions of large corporations.

Thirdly, it is astonishing to hear some senior bankers declare that, if certain prevailing practices are deemed acceptable by people in that society and are not judged illegal, they should not impose their values and refuse to serve as a banker. They argue that it is the role of government to legislate and they should comply with the laws but not have to go beyond that. They are therefore apathetic about community values and environmental protection measures as contained in the Equator Principles. While those few banks that opt to subscribe to broader ethical criteria are indeed commendable, it is important to note that there are many who disdain such action and would only go along with this in order to enhance their 'reputation' in the marketplace and push their marketing efforts.

The problem stemming from the above observations is that investment banks have been able to invent a myriad of complex financial instruments which banks and other lenders have been so keen to promote and sell to all their customers over the past decade without either comprehending themselves or explaining to the ultimate buyers what the intricate and perilous risks could and would become. This predicament foreshadows the failure of sub-prime lenders to assume responsibility for their actions and a breakdown in transparency.

E. Foreign Exchange and Securities Trading

Trading room activities are unique because banks execute transactions for two very different purposes, namely the needs of their clientele and profit generation for themselves. The foreign exchange needs of clients arise from exports and imports of goods and services, cross-border investments, and travel expenses. Foreign exchange trading underpins the international payments systems. Banks acting as principals engage in so-called proprietary trading in many situations, for example, when they act as a 'market maker' in a certain currency or when they perceive an apparent disparity between current and forward rates and decide to take an arbitrage opportunity. Trading on behalf of clients entails significant conflicts of interest (because there is constant temptation for the bank or the individual trader for self-dealing), so well-managed banks enforce client confidentiality, segregation of duties,[164] restriction of personal dealing,[165]prohibition of dealing outside the bank's premises and after-office-hours trading, and systematic checks by internal and external auditors. Proprietary trading carries financial risk for the bank, which must determine that there are appropriate controls in place so that the risk capital is not unduly impaired. The ethical problems arise when the individual traders seek their own personal financial gain ahead of the clients or the bank.

Securities trading involves transactions on behalf of the clientele as well as for the bank's own account. The securities consist of both equity and debt instruments, including asset-backed securities. This is the area in banks that is responsible for funding loans as well as selling off and dealing in loan assets. Since conflicts of interest need to be avoided, segregation of duties and restriction on staff dealing are imposed. Every bank has a Code of Conduct that provides guidelines for avoidance of conflicts and ethical problems.

In many banks there is a positive correlation between the compensation of foreign exchange and securities dealers and their performance in terms of trading

[164] Between front or those liaising direct with the clients, middle or those who execute the trades, and back office or those who process the trading orders.
[165] Employees in the front-middle-back office of the foreign exchange department are forbidden to conduct foreign exchange trading for their own personal accounts.

profit. The danger here lies in the enticement for dealers to assume an overly speculative foreign exchange or securities position. The measures of control are embedded in the dealing limits and the other restrictions above. The basic problem is that such dealers are motivated primarily by the financial gains they produce. The recommendations for improvement include staff training on compliance and business ethics, but it is objectively difficult to judge whether such an approach is really effective.

In the view of two senior bankers in Hong Kong that city has developed into the third largest financial market in the world and in order to attain this status it has needed to be well-disciplined and well-governed. In speaking about their organisation they asserted that integrity begins with the people thy employ, because "their individual ethical standards of behaviour are the bedrock of the integrity of an organisation." The recruitment process is therefore very important for this bank. Once the employees are admitted, the long-established core standards of the group provide the moral compass.[166]

There is a general acceptance that any large financial services entity faces potential conflicts on a regular basis, so for bank managers the key to managing these successfully is to have a vigorous structure that sustains the separation of the private activities (banking / relationship / advisory) from the public activities (research / trading / sales). Internal controls and audit functions are deemed essential in managing a prudent and secure system.

Most banks employ control procedures in order to prevent conflicts of interest and fraud. Although each financial institution might have a varied approach, the procedures usually include specific rules on trading limits, designated separation of

[166] Transcript HK 4.

functions, and robust auditing.[167] The emphasis is on prevention, which seeks to avert placing dealers and operations clerks in situations that might entice them to commit fraud or theft.

The principal control mechanism used by banks in Hong Kong is a clear segregation of duty, which means that on a bank-wide level, they would have different departments looking after each risk category. Dealers in the trading room strike deals within their defined trading authority limits. Dealers acting for customers are strictly separated from those acting for the bank. The settlement division is responsible for deal settlements to ensure that all orders have been executed and all parties to transactions have fulfilled their obligations. A controller from the finance department independently verifies the trading positions, while the risk management department also monitors daily transactions.

In addition to the separation of functions, the audit department carries out periodic audit checks to ensure compliance with related policies and procedures. Internal guidelines and codes of conduct are set up for all dealers to follow. These guidelines include issues related to regulatory requirements and ethical values. External accounting firms also perform external audits over and beyond these internal controls.

In certain institutions there is a belief that education is very important in uplifting the integrity of the staff. Human resource departments set up various educational approaches to reinforce the importance of work ethics. They hold regular talks and seminars on regulatory requirements and the bank's internal requirements. Some banks in Hong Kong, such as Panda, periodically invite officers from the

[167] Written submission from Panda Bank on 28 October 2006.

Independent Commission against Corruption to come and talk about work ethics and regulation.

This system of controls, segregation of duties, and internal audit is standard practice at banks that wish to avoid conflicts of interest and discourage fraudulent self-dealing in the frenetic environment of global currency and securities trading. The overt reference to education is noteworthy because there is acknowledgment of the role of education in values formation.

One striking observation is that a leading bank in Hong Kong does not have a dealer bonus compensation programme that rewards them for income or volume contribution, which is the norm at most banks.[168] There was recognition that a bonus incentive scheme would motivate dealers but also worry that, if such a monetary inducement was too performance oriented, it could prompt dealers to assume excessive risk or engage in devious trading to enhance their results. There was a conscious decision that trading performance as measured by an individual's trading volume and income would not be the sole critical element for determining annual compensation for dealers.

In the Australian scenario credit unions, community-based banks, and medium-sized banks that cater mainly to individuals typically do not carry out any foreign exchange or securities trading on their own and outsource their requirements in these specialties to their respective correspondent banks. The demand for these trading products among smaller banks is generally low. These institutions therefore have less complicated organizational structures and fewer market and operational risks.

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[168] Transcript HK 10.

The major local banks, which deal with large corporations, and the foreign banks have extensive activities in foreign exchange and securities dealing. These institutions normally operate on a global scale to deal in currencies, trade in securities, and fund the requirements of the respective banks. Active dealers trade on every major financial market in virtually all time zones. Dangers are always present because of the customary trading frenzy, so banks have in place a system of controls similar to that in Hong Kong as described above.

Trading in the Australian market has been depicted as generally free of fraud despite the isolated well-publicised case that occurred in January 2004 at a major bank.[169] Dealer fraud is normally spotted in the back office or through alerts in the market that would trigger an internal investigation. But the culture of that bank did not support the back office, which had protested that something was amiss, and therefore the errant traders in the front office prevailed. In addition, the co-workers themselves ignored the warnings of market players in other banks who had spotted the anomalies.

The classic trader mentality is portrayed as aggressive and motivated solely by profits and bonuses, hence there is a need for unambiguous separation between the front and back offices, and there must be good monitoring and strong compliance. But problems and deception do occur as well as occasional momentous crises.

One large bank, Koala, revisits the issue of currency and securities trading every time a global crisis occurs. It constantly tests for openness and transparency. Koala has in place processes and protocols to give a controlled environment, such as reporting requirements, separation of duties, and internal audits. But ultimately there

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[169] "Heads Roll at Nab over Foreign Exchange Scandal," *Sydney Morning Herald*, 12 March 2004, http://www.smh.com.au/articles/2004/03/12/1078594547046.html?from=storyrhs (accessed on 3 June 2010).

is the belief that the culture of an organisation and the degree of transparency are the determining factors whether people will seek to hide or manipulate their situation. Culture impels people to do the right thing.[170]

There are three courses of action that Koala Bank advocates:

1. The management has to understand what their varied businesses do and what all the employees are actually doing. Hands-on management is vital.

2. The management should encourage a culture of speaking up and 'not shoot the messenger who delivers bad news', so people are not uncomfortable in raising unwelcome topics. This is the important notion of the whistle-blower.

3. Foster teamwork. The bank must motivate bank staff to share what they are doing; it should discourage a lone wolf mentality. A well-managed bank tries to create an environment that would not encourage an individual to manipulate his / her individual profitability for personal gain, so the bonus compensation formula would not drive an individual's outcome.[171]

Things can and do go wrong. As mentioned above, a major Australian institution encountered a foreign exchange debacle in recent years when four FX options traders were discovered to be acting in a fraudulent manner and, though their immediate superiors might have been aware of the wrongdoing, they turned a blind eye because everyone's bonuses were structured towards their doing well. It seemed that the primary reason was the cultural environment, meaning that the management did not do enough to examine potential risks in the business.[172]

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[170] Transcript AU 3.
[171] Ibid.
[172] Transcript AU 8.

In the opinion of bankers it is impossible to eliminate fraud or inappropriate activity in the dealing room or any other form of business but it is important to understand what the potential risks are, assess what level of risk is acceptable to the company, and then install a set of controls and mitigants to reduce risks to the level with which the institution is comfortable.

The view seems to be that the way to prevent dealing room fraud and reduce the risks is through a control process at three levels of defence:[173]

Firstly, at the business level the managers should ensure that employees have strong capability and this starts during the hiring stage when a separate group from the hiring entity carries out reference checks on the candidates' probity and accomplishments. Once people join the bank, they must undergo compulsory and on-going training, some of which is product focused to make sure that the staff know the products well and can communicate these to clients. In another training component the employees must understand the code of conduct and how the bank wants to treat clients. Successful completion of the latter form of training is a pre-requisite to continuing employment at the bank. Employees are also strongly encouraged to pursue continuing education outside of the business specialty.

At a second level of control there are checks and balances through separate risk management and compliance. Through this process employees can raise risk and compliance concerns either through managers in the line of business or escalate these directly to the independent compliance group. This would come under the *whistle blower programme.*

[173] Transcript AU15 is with the overall head of foreign exchange trading of a major bank.

Thirdly, internal and external auditors regularly examine activities to ascertain the absence of fraud. Audit functions have assumed more importance in reinvigorated corporate governance at all banks. Yet cynics would say that *outlawing dishonesty is very difficult and all problems in dealing rooms have always involved dishonesty.* Despite all the attempts to impose controls this might be the prevailing attitude among top bankers. The following highlights a glaring example.

During the week of 21 January 2008 when the share markets around the world began tumbling down in terror of the portents of American recession, another momentous scandal blew up in the dealing room of the respected French bank, Sociėté Generale.[174] The announcement stated that a single dealer, Jerome Kerviel, had substantially exceeded his dealing limits.[175] The markets were shocked to discover that this solitary dealer had placed the bank's capital at risk to the tune of EUR 50 billion, which was more than the capital of the bank at that time. After learning of this fraud, Sociėté Generale undertook to unwind the numerous put options on which Mr. Kerviel had gambled; he was betting that the German stock prices would collapse. It was alleged that Mr. Kerviel came from a mundane background and did not stand out from his colleagues, but that he had earlier worked in the middle room operation of another bank, which provided him the technical expertise to enable him to circumvent controls on his personal trading.

Although police and regulatory investigations were still underway, statements from Mr. Kerviel claimed that he was not seeking to make a fortune for himself but rather to achieve recognition for his brilliant efforts in earning profits for the bank.

[174] John Lichfield, "'Rogue Trader' Breaks His Silence and Insists His Bosses Knew What He Was Doing," *The Independent*, 30 January 2008, http://www.independent.co.uk (accessed 1 February 2008).
[175] Each dealer or trader in a dealing room (shares, bonds, foreign exchange, or derivatives) has a specific daily monetary limit to which he / she must strictly adhere, and this is closely monitored by the so-called middle and back room staff under computerised surveillance.

He said that his performance until the end of 2007 was excellent, even if he only received a slim bonus, so he insisted that his superiors must have been well aware of his strategy and tactics.[176] According to reports, he took very little vacation (unusual especially for a Frenchman) and always worked at night, which should have triggered an investigation much earlier. Indeed some exchanges, notably EUREX in Frankfurt, had complained to the bank about irregularities resulting from this dealer's transactions, but the bank consistently rebutted the allegations. The cost of the unwinding of the unauthorised transactions was expected to result in a loss to the bank of EUR 5 Billion, which was a hefty slice of the bank's capital and would drastically impair all its stakeholders.

While this is an amazing case of gross fraud perpetrated by one individual who was supposedly familiar with the computerized system used to monitor and audit each trading transaction, one would deem it a clear illustration that all the processes and controls of a bank can be sabotaged and overridden if people engaged in the activity do not have a culture of honesty and values and want to commit illegal acts. If Jerome Kerviel's claim was honest, that he did not personally profit monetarily from his illicit trades, then his motivation of wanting to achieve fame was certainly based on false values and a lack of morals. Moreover one would surmise that this trader's immediate supervisor and senior managers must have been so pleased with the previous income and profits that he was earning for the bank that they did not bother to scrutinize his methods. Truly competent managers should thoroughly know their products and understand the processes underpinning them. Good honest management would have quickly realized that extraordinary profits under normal

[176] Jeremy Warner, "A Crisis Entirely of Socgen's Own Making," *The Independent*, 29 January 2008, http://www.independent.co.uk (accessed 30 January 2008).

conditions could only have arisen from taking excessive risks or engaging in fraudulent trading. The ethos of integrity must commence at the top.

F. Code of Conduct

Every bank has a Code of Conduct, which is an affirmation from its board of directors and senior management of the values of the bank and the desired behaviour of every employee. Other names are used, such as Ethical Code of Conduct, Principles and Values, or Corporate Principles. Many banks provide web links to their respective Codes on their corporate websites, so customers and the public at large can peruse these. There are similarities in the stated principles and values, though some banks have a more extensive list, which could comprise several topics. Business principles might include outstanding customer service, effective and efficient operations, strong capital and liquidity, prudent lending policy, strict expense discipline. Some acknowledge the importance of employee loyalty and dedication in fostering lasting customer relationships and achieving teamwork.

In addition, banks also declare key business values, which could consist of several benchmarks such as the highest personal standards of integrity at all levels, commitment to truth and fair dealing, hands-on management at all levels, commitment to quality and competence, a minimum of bureaucracy, fast decisions and implementation, putting the team's interests ahead of the individual, the appropriate delegation of authority with accountability, fair and objective employer, a diverse team underpinned by a meritocratic approach to recruitment / selection / promotion, a commitment to complying with the spirit and letter of all laws and regulations wherever the bank conducts business, the exercise of sustainability through detailed assessments of lending proposals and investments, the promotion of good environmental practice and sustainable development, and commitment to the welfare and development of each local community.

A few banks state that their reputation is founded on adherence to these principles and values, and that all actions taken by officers and employees should conform to the publicly declared code. A bank in Hong Kong defines its core values as Customer Focus, Focus on Quality, and Integrity / Honesty. Integrity is defined in this bank as exhibiting and practising the highest ethical standards, recognition for the highest standards of corporate governance, and a relationship with customers characterised as honest, trustworthy, reliable and dependable. The bank's top management enunciated these values that were then developed into a mission statement by the strategic planning department and disseminated throughout the organisation.

New bank recruits are required to attend an induction course that explains these core values. During regular performance appraisals managers and supervisors are expected to take these values into account when determining the key performance indicators of bank staff. Furthermore the mission statement is displayed as a screen saver on workstations to constantly remind employees of the core values.

The bank acknowledges that its values have evolved as a result of growing awareness of consumer rights and the influence of guidelines issued by the Hong Kong Monetary Authority. There was a candid admission that policies were previously one-sided, that is, designed to solely protect the interests of the bank. Since then, the bank has reviewed its contracts in order to assure fair treatment for customers.

There is a unique prototype in a bank that has preserved its local tradition of customer service and integrity over many decades while its affiliation with a global network has enhanced its values because the whole group subscribes to the highest international standards. It has retained old clients while gaining new ones because of its perception as a traditional local bank.[177] Its culture is perceived to be more conservative but service-oriented than its parent bank, which is viewed as very professional and efficient but cold.

Yet, in spite of its warm and welcoming image, this major local bank (in common with many others) employs tiered pricing whereby customers with larger deposits, more accounts, or bigger loans – in other words, those who contribute more income to the bank – receive more benefits and favourable pricing. The wealthier clients pay comparatively lower rates than those less well off. This is one example of utilitarianism at work in banking; it would be deemed an ethical dilemma by contractualists.

A former chief executive asserts that the culture of his previous bank, Dragon, is imbued with ethical practice, which is documented in a code of conduct distributed to all staff members, who must certify that they have read and understood it. Transgression of the rules and the code is subject to severe penalties. There is a claim that the bank would rather forego a piece of business than lose its reputation. Since the organisation is global in its operations, it is subject to countless regulatory authorities and it therefore allegedly takes the highest common denominator, oftentimes enacting internal regulations stricter than required under pertinent local laws. Hence many of its practices have allegedly been adapted by both the HKAB and the HKMA.

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[177] Transcript HK2.

The Dragon banker asserted that one cannot necessarily teach people to be honest and can only hope that background checks on new recruits can give an indication about their character. He elaborated further.

> The only way you can really deal with it is to make sure that the most senior people have achieved their positions because they have demonstrated not only the ability to do the banking business but also that they follow the set of principles that you would wish anybody else to follow. And if they follow those principles, the chances are they will make sure that other people who are working for them follow those principles, and so it goes on down through the organisation.[178]

The Dragon executive added that once the leadership has set the right example that is emulated throughout the institution, then it becomes easier to spot someone who is prepared to cut corners or to take risks without asking questions. Occasions arise when young, enthusiastic new hires want to do things faster and, in their opinion, better and ask if they can try a different procedure but are refused because they are told it has always been done the other way. According to this senior banker:

> very often they are told that because doing it any other way has been tried and has not worked. What happens then is that they go ahead and try to do it anyway. When something goes wrong, they then cover it up.[179]

Within Asia and several other cultures there is in Dragon almost a zero tolerance for faults arising from infringement of rules. Those involved in such breaches of ethical conduct are severely penalized, but, if they deny their transgression and conceal it, they compound the problem by not owning up to it and by continuing to do it in order to hide whatever the lapse of which they were guilty. This chief executive subscribes to the principle that a well-managed bank does not want surprises. If somebody commits a blunder, one should admit it straight away because there could still be

[178] Transcript HK4.
[179] Ibid.

remedies but, if one just carries on, it could be too late. He would prefer that individuals ask questions if they do not understand processes so they might be able to approach them correctly rather than make guesses and get them wrong.

Despite this bank's concern about ethical conduct and its reputation, it was one of the few foreign banks that acquired a major sub-prime lender in America but when it recognized the hazards in 2007 and its subsidiary was engulfed in a sinking housing market and mortgage loan defaults, it was quick to admit that it had made a mistake and was probably the first major bank to exit that business. This will be revisited in Chapter 6 where the American sub-prime activity is dissected.

Due to their diversity the Australian financial institutions in the research study have wide-ranging codes of conduct. At one end of the spectrum there was a credit union that defined its values as respect, responsibility, and excellence. It arrived at this affirmation after an internal process of dialogue among the managers. Presumably these values refer to respect in the organisation for one another and for its customers / members, responsibility for one's actions, and excellence of service towards its members. The institution strives to market these values to all its staff members.

A typical large bank expresses its code of conduct as corporate principles, which are comprised of behavioural and compliance standards, the latter defining how employees need to act according to various statutory regulations under which the bank operates. In a major bank the behavioural benchmarks resulted from a survey of 5,000 staff members who were asked: *"What are the standards of corporate behaviour that you would expect in a company for which you would like to work?"*

The responses have been distilled into a one-page statement of corporate principles that is provided to all bank employees.[180]

The bank highlights five principles:

1. Openness and honesty.
2. Responsibility and accountability for one's actions.
3. Teamwork and collaboration.
4. Respect for people.
5. Speed, simplicity and execution of promises.

Each employee must go through and successfully pass two gates during the mid-year and the yearly performance reviews. These are the tests for behaviour and compliance. There are three possible colour-coded outcomes: green, signifying that the employee is acting according to desired expectations; amber, which indicates there are areas for improvement; red, meaning the person is significantly in breach of the standards.

The statistical results, specifying the distribution of green, amber, and red scores, are reported to the board of directors and the regulators to show the extent of cultural change in the organisation. The management is not uncomfortable with an increasing number of amber scores because these suggest that employees are prepared to identify compliance infringements, so compliance officers can take steps to mitigate these. These are also viewed as signs of rising standards.

Personnel compensation is comprised of a cash salary, a short-term incentive in the form of an annual bonus, and a long-term incentive. With a red score an employee is not eligible for any bonus; one with an amber score is penalized with a

[180] Transcript AU18.

significant reduction of approximately 50% on any potential annual bonus. This system therefore operates as a stick.

This benchmarking system was developed as a result of the foreign exchange options fraud that was perpetrated at this bank as described in the earlier section. After the foreign exchange scandal, top managers realised that a significant contributor to poor ethical behaviour was that they only measured sales, so they introduced behavioural standards as well as compliance standards, which would form part of the gateway to performance evaluation. But compliance standards were detached from behavioural standards with which a senior compliance officer disagreed because compliance should be deemed a combination of process and behaviour.

Eight behavioural standards such as openness and honesty were identified that all organisations should have. There was the belief that even with the best processes in the world compliance would not occur without proper behaviour because people could continually work around the process, which was what happened in the foreign exchange options case.

The staff at Bandicoot must pass the behavioural standards and the compliance standards before they can even be considered for their sales targets. The results in 2006 for the three compliance standards were: green – for 90% of all staff in Australia, meaning they could go straight to performance appraisal; amber – evidence of bullying or harassment or cutting corners – for which the maximum they could earn was capped at 50% of their entitlement; red – unacceptable behaviour such as accessing pornography on the internet at work – for which the gate was shut. Ten per cent of employees were assessed amber and red. Of 22,000 employees in Australia 70 people were caught red (someone was discovered spending 20 hours a week watching pornography at work) although this did not necessarily result in dismissal.[181] Pornography itself is fraught with moral problems while those depicting paedophilia are illicit; accessing it in the workplace indicates ethical deficiencies in an individual's values and violates the employer's stated code of conduct and diminishes an employee's work contribution.

The rating method instils fear in the staff in relation to the behaviour gates and the compliance gates. The worrisome aspect is that the principal motivator in this organisation is a stick, that one must do certain things in order to avoid punishment. It encourages behaviour that has not been developed from within the individuals, so the use of a threat has limitations.[182]

In a well-structured incentive system superior management recognizes good and bad achievement and does not merely grant a straight bonus reward. But in striving for a balanced scorecard there seems to be difficulty with subjective measures of behaviour and not recognizing financial results.

Nonetheless there is an allusion to a high correlation between good behaviour and economic success. A top executive discovered that first-class corporate bankers are nice people because prickly people, who are tough to deal with, do not progress well. In the business context society is attracted to people with positive characteristics. If an individual does not share the values of the group to which she belongs, that group consciously or unconsciously isolates that person, who realizes she is in the wrong spot and moves on.[183] The same holds true for customers who will avoid those with whom they do not share similar values and will either go to another

181 Transcript AU 8.
182 Ibid.
183 Transcript AU 9.

bank staff member or transfer to another bank. In the end people with unattractive characteristics do not thrive.

Due to expressed concern that banks have encouraged consumerism through the use of credit cards, some retail bankers admitted that there are people at the margin who have not managed their finances well and have taken on too much debt. But a major bank proclaimed that their institution was the only one that had introduced a 'responsible lending policy.' This ensures that borrowers are in a position to repay their debt. In comparison with world patterns, including the US and UK, Australia has very low credit card usage. This bank is not interested in promoting credit cards with marginal, sub-prime clients.

This well-managed bank regards itself as a major blue chip Australian company serving millions of people and its reputation is built on trust. The retail banking head at Kangaroo said: "*There is plenty of money to be made playing the game straight with people who have jobs and own their homes. We are not interested in bottom feeding.*"[184]

Values are very important for this bank and are part of its culture. Kangaroo commenced a programme five years ago with the objective of re-energizing the culture at the institution.

> As a bank, you are not just a shoe store, not just another business earning income. The bank plays a really important role in the life of a community. Having a banking license is a privilege, not a right. With that comes responsibility – to contribute to the economic health and life of the community. So the bank staff see they are not merely earning a salary, but they are making a contribution to the community. So it is not congruent with that philosophy to cut corners or try to make a quick profit.[185]

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[184] Transcript AU 4.
[185] Ibid.

The bankers at leading financial institutions agree that there is something intangible in the tone from the top, in the climate set by the board and the most senior executives in an organization.[186] This is very important and is manifested in an aura of openness and the extent to which top managers declare their own preferences with respect to ethical behaviour. If top executives are perceived to be self-seeking or interested only in short-term outcomes, that impression permeates the whole organisation. On the other hand, if the directors and top executives are genuine in their desire for the long run health of the bank and not just their own interest and are involved in building an open and constructive culture, that likewise pervades the rest of the firm. One cannot underestimate the power of corporate culture, of the power of the most senior leaders in the group in setting that climate. Leaders create the climate. If leaders do not set the climate, they should not expect the rest of the organisation to do so.

There appear to be universal characteristics intrinsic to banking that are independent of where it is undertaken, which explains why international banks bring expatriate staff to their foreign locations as bearers of their unique banking culture. Many local people choose to join foreign banks because these have a style different from local banks. This phenomenon seems to imply that respected international banks articulate a highly admired code of conduct throughout their global network.

However, as seen earlier, there is also an opinion among some bankers that a bank's values should conform to the values of the community in which they live and work and should not be self-imposed or different. They contend that they should ignore public opinion polls and only pay attention to legal strictures. These bankers

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[186] Transcript AU 3.

argue that it is the role of politicians to write the laws to reflect the values of the community.[187]

According to this line of thinking there are sufficient laws to protect the environment and the community in accordance with the best interests of everyone so there is no need for bankers to have a higher set of standards than these. Looking at this reasoning objectively, there is the assumption that all laws are sincerely enacted with ethical considerations, but it is common knowledge that political lobbyists earn their living by trying to influence lawmakers to write legislation favourable to their special interest groups. Therefore certain laws could possibly be defective due to a lack of political will. Even if some laws have desirable objectives, loopholes are sometimes integrated that preclude effective compliance.

In resisting environmental protection measures, adherents of the compliant position referred to above argue that bringing to bear a set of considerations beyond what is required by the laws of the country is not the role of bankers. They declare that banks have a responsibility to provide a service to the community, which is the basis of their business. It is these bankers' opinion that moral questions in a democratic system reflect community standards and are moveable issues:

> the values today may not be the same tomorrow, and these values are enforceable through the process of law. Bankers have no right to change that by insisting on their own values and standards.[188]

This argument looks at morality as purely subjective and diminishes the possibility of grounding these in objective and absolute values. A reflective independent onlooker must disagree with this relativistic approach to morality, which is a major reason that banks have caused so much harm to individuals and communities. This is the

[187] Transcript AU 9.
[188] Ibid.

philosophical rationale behind political attempts over the past decade to promote deregulation of the American financial markets.

This predisposition has likewise carried over to the issue of the Equator Principles, which prompted some banks to declare that they were sceptical of manifestos on the environment prepared by non-governmental organisations (NGOs) and have therefore developed their own codes of principles, which are supposedly 90% congruent with the Equator Principles.

While adopting a self-interested perspective, these banks attempt to rationalize their position, which appears to be utilitarian in tone. As the senior corporate banker said:

> What is to be gained by associating oneself with a person or a company that is wilfully destructive? The chances of that person having a bad debt are high; the chances of that person having the right standards are low. Making a loan is easy but getting repaid is difficult. A company with poor work practices and safety standards illustrates lack of control, so there is likewise a high probability that their finances are not under control.[189]

G. Bank Self-Assessment

As necessary elements of their codes of conduct, banks measure themselves according to two important criteria: customer satisfaction and the employee opinion survey (EOS). The EOS, which is conducted annually in all the Australian banks, attempts to gauge what the employee thinks of the organisation for which he or she works. One of the big four banks rated highly at 60%, which meant that most employees were satisfied or very satisfied and liked working in that bank. The others

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[189] Ibid.

rated poorly; one particular bank had a dreadful score of 32%. The general manager for Australian compliance of that bank, Bandicoot, said:

> Therefore, if only 32% are satisfied employees, one could infer that half of the remaining 68% are indifferent, who are unhappy working there, and the other half are saboteurs, who not only do not like working there but also try to destruct the place where they work. This is a reflection of how they deal with their customers because they are under constant pressure to sell. The customers become a means to an end rather than an opportunity to do the job right. This score tells us that 68% of the people do not really care if they do the job right or not.[190]

The corollary measure is customer satisfaction, what customers think of the banks. Typically *only 20% of customers said they were happy with the large four banks* (though the one that rated highly in EOS also had a better ranking here), while 40% of clients said they were pleased with the services of two smaller, well-known banks. *The reason people stay with their banks is convenience: it is so hard to move.* The Bandicoot compliance head described this further:

> The situation is one of unhappy customers whom the bank targets for a greater share of business, sold by people unhappy to work here. The consumers think their needs are not genuinely understood because the banks only think of themselves. The staff do not think their needs are genuinely understood because they are under so much pressure to do well for the bank and not necessarily meet the needs of customers. *So they are caught in a dilemma; this environment breeds conflicts and ethical problems.*[191]

The two smaller institutions that are well regarded by consumers have fewer products and listen to customers. They have fewer conflicts and have a structure that enables them to reflect on why they are in business: to satisfy their customers.

[190] Transcript AU 8.
[191] Ibid.

Unfortunately in large organisations the desire is not to satisfy the customers but to satisfy the shareholders.[192] This is an irony in that customers are also directly and indirectly shareholders in large institutions. Australia has one of the highest shareholding in the world, because individuals either directly own shares in banks or through their superannuation funds. The stress on shareholder value enhancement is intrinsic to theories of financial management and corporate governance, so this unleashes the potential for conflicts of interest.

A major non-bank lender, Bilby, claims that it regularly upgrades employee benefits so that people are attracted to the company and want to work and stay there; this comes even though new government regulations are scaling down benefits. The firm's cash compensation rewards depend on the job classification.

How does Bilby validate that employees are truly serving the customers? Every single phone call is recorded and audited. Complaints against collectors are immediately investigated. The review of recorded customer phone calls examines how the staff or collectors handle customer requests and complaints.[193]

To test for customer satisfaction Bilby also regularly monitors the degree of closeness of the customer to the institution by asking them '*How likely are you to recommend this product to a friend or a colleague?'*[194] This is a measure of customer loyalty and satisfaction. A score of 9 – 10 designates an advocate or promoter; a score of 7 – 8 signifies those who are neither here nor there, who could jump ship; a score of 6 or below indicates deeply dissatisfied customers who will leave as soon as they can.

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[192] Ibid.
[193] Transcript AU 11.
[194] Ibid.

Bilby's results in the employee opinion survey are described as good but it is constantly seeking to improve the correlation between satisfied employees and business success. The EOS scores provide ideas on areas where improvement is possible.

In addressing the dilemma where the richest customers pay the lowest rates and the poorest are charged the highest interest rates, the response by Bilby's compliance manager pointed to the need for profits:

> If you charge a lower rate on a high-risk loan in a tight margin environment such as Australia, then you have no leeway built in if you start to have defaults and you are just in a loss-making business. People are in business to make money.[195]

This is the fundamental problem one sees in lending to the sub-prime sector. The sub-prime individuals generally have higher credit risk, but they are also entitled to certain necessary basic items, such as a home. But extending credit at high rates could border on being usurious.

However the staunch belief of this firm is that responsible lending is a key principle for them. The compliance manager said: "We not only want to be a great company, but we also want to be a good company."[196] They have a major volunteer programme in community involvement whereby every employee is allowed and expected to spend a day a year performing volunteer work in communities. This manager disclosed that he himself dedicates much more time than this.

The company also has guiding principles on ethical conduct set out in a booklet and on the company web page. To implement these, Bilby requires all employees to complete and pass *monthly training on compliance* (most banks insist

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[195] Ibid.
[196] Ibid.

only on annual or quarterly guidance). The policies cover a wide range of ethical standards relating to employees, customers, suppliers, governments, environment, money laundering, privacy, international trade, and competition. *The company wants to do the right thing and be seen doing the right thing.* Bilby's ethical principles claim to *focus on the right thing to do for customers, the community, and the employees rather than what are legally permitted.*[197] This assertion diverges from the opinion of some executives who said that legal compliance should be the sole concern of banks.

Reputation is very important for Bilby especially because its parent group has frequently been chosen as the most respected company in the world. The group has many diverse businesses whose products are vastly different from each other, but they are connected through shared values and behaviour, through a common culture of how they live and work. Indeed several banks stressed reputation as a key element in their code of conduct.

It was therefore very distressing for a large well-regarded bank to discover in 2008 that it had engaged in activities damaging to its reputation.[198] Due to the financial liquidity squeeze stemming from the sub-prime crisis in America, credit had become nearly impossible to obtain in Australia as well as other countries. This situation inflicted severe difficulties on non-bank financial institutions that had no customer deposits and had to rely on loans from traditional banks. This was certainly the state of affairs for stockbrokers. In a well-publicized case two brokers had been providing margin facilities to their customers to enable them to buy shares of stock through the brokers, which loaned them money and retained the securities as collateral, which they in turn pledged to their bank in order to fund themselves. Due

[197] Ibid.
[198] Transcript AU 19.

to the turbulent financial climate these two stockbrokers failed and declared bankruptcy. Although the clients of the brokers had signed agreements allowing transfer of ownership of securities, they might have expected the lending bank, which was holding the securities, to return these to the clients in the event of insolvency of the brokers. However, in order to protect itself and recover a portion of the loans it had extended, the bank foreclosed on the collateral and sold the shares in the market. The bank was therefore regarded as acting in its own interests at the expense of the clients of the brokers.

This was a considerable blow to the reputation of the bank, so its chief executive immediately formed a task force to investigate the circumstances. After an extensive enquiry the committee released its lengthy report, which the bank disclosed to the public and posted on its website. This would be regarded a very good example of transparency. Among the negative findings was that the responsible officers did not really understand the product or the distinction between security loans (where the bank lends the physical securities to brokers) and equity loans (where the bank lends money to brokers which pledge securities as collateral). Without a clear awareness of the full ramifications of the product the bank did not have appropriate policies and procedures with regard to credit limits and risk management. There was also poor accountability and a failure to identify and act on warning signs. On the positive side the report indicated that the individuals concerned had not committed any deliberate wrongdoing, although two persons were found in violation of potential conflicts of interest in not having disclosed to their supervisors that they conducted personal trading through the affected brokers; they have since been dismissed. The enquiry concluded that the bank had acted in accordance with legal provisions but had not instituted a system to protect its reputation and minimize harm caused to innocent third parties. The bank has subsequently decided to eliminate the equity finance product. It has also announced an upgrade of its code of conduct and relevant policies.

This episode demonstrates how lack of complete familiarity with a product that a bank offers can pose enormous risks for both the bank and other parties and result in unethical conduct. Once the predicament was spotted, the bank's chief executive took decisive action and displayed transparency.

CHAPTER 4. SELF-GOVERNANCE AND STATE REGULATION

A. Code of Banking Practice

In addition to a Code of Conduct proclaimed by individual banks, Hong Kong and Australia each have a Code of Banking Practice issued by the respective banking associations. In order to appreciate the banking situation in Hong Kong it is worthwhile to look at the Hong Kong Association of Banks (HKAB) and to examine its role and its relationship with the Hong Kong Monetary Authority (HKMA), which has the exclusive power to approve the establishment of licensed banks, restricted banks, and deposit taking companies, but the focus in this dissertation is only on licensed banks. Once a bank receives a license to operate, it has a statutory obligation to become a member of the HKAB, which has traditionally had a pivotal role in the establishment of banking practices and guidelines. The locally established banks are entitled to select their own representatives, whereas the foreign banks have to choose representatives according to their geographical grouping. The HKAB has three permanent members, namely the Hong Kong Bank (HSBC), the Standard Chartered Bank, and the Bank of China, each of which rotates annually as Chair of the HKAB. These three are not only the largest banks in Hong Kong but also have a notable statutory function, namely as officially designated note issuers of the Hong Kong currency, which is a unique privilege held only by central banks in other countries.

Until the relatively recent establishment of the HKMA, which subsumed the previous Commissioner of Banking, the HKAB had a much broader unofficial role.

Not only did the three permanent members issue the currency, but also effectively established the interest rates, and thus the HKAB was referred to as a banking cartel. The HKMA has endeavoured to break up the interest-setting cartel by stipulating that market forces must determine interest rates. Despite this measure, the three permanent members remain the largest banks, continue to be the official note issuers, and dominate the monetary trading, so they exert considerable influence on interest rate movements and are effectively the market makers.

These permanent members perform another key role, which is normally carried out by the central bank of the country, namely as the official clearing banks: HSBC and HKMA for US Dollars, HSBC for HK Dollars, and Bank of China for PRC RMB (Chinese Renminbi). In its role of US Dollar clearing HSBC cooperates closely with the Federal Reserve Bank of the United States.

Together with the Deposit Taking Companies Association, the HKAB has also issued the Code of Banking Practice (COBP), which is intended:

(a) to promote good banking practices by setting out the minimum standards which institutions should follow in their dealings with personal customers;
(b) to increase transparency in the provision of banking services so as to enhance the understanding of customers of what they can reasonably expect of the services provided by the institutions;
(c) to promote a fair and cordial relationship between institutions and their customers;
(d) through the above, to foster customer confidence in the banking system.[1]

[1] HKAB, "Code of Banking Practice," ed. Hong Kong Association of Banks (Hong Kong: 2006), http://www.hkab.org.hk/DisplayArticleAction.do?sid=5&ss=3 (accessed 30 November 2006).

The HKMA fully endorses the COBP recommended practices and standards, and expects all banks to take active steps to ensure full compliance with the COBP, which some senior bankers believe actually emanates from the Authority. It believes that the COBP will help to further enhance the transparency and quality of banking services in Hong Kong as well as Hong Kong's status as an international financial centre. As part of its regular supervision and to set up the monitoring of banks' compliance with the COBP, the HKMA has required all banks to commission their internal audit departments or other equivalent units to conduct an annual self-assessment of their compliance with the COBP. The self-assessment results are required to be submitted in the standard template to the HKMA by the timeline as imposed by the HKMA. The self-assessment aims to encourage banks to rectify any weaknesses identified at an early stage. Where non-compliance areas are identified during the self-assessment process, banks should specifically provide the details, remedial plan and the target completion date. The HKMA closely monitors banks' progress in implementing the rectification plans. The self-assessment results also enable the HKMA to analyse the compliance position of individual banks, with a view to identifying common issues within the banking industry and developing supervisory guidance over the longer term. Although no penalties are specified for failure to submit reports, a non-cooperative manner would adversely affect the HKMA's outlook on the bank's practices in providing services to its personal customers. From one perspective, even if the COBP is voluntary for banks, the mandatory self-assessment of compliance for all banks is a clear signal that it is an instrument of banking supervision. The HKMA may undertake more frequent and stringent on-site examination to supplement its supervisory function.

During the course of the Hong Kong research, interviews were granted by the current and the previous Chairmen of the HKAB, who were chief executives of their own major global banks but were able to speak about the entire industry because of their position as industry spokesmen and also to comment on the occasional tension between the banks and the regulators.

Looking at Australia, the Australian Bankers' Association (ABA) works with its members to provide analysis, advice, and advocacy and contributes to the development of public policy on banking and other financial services. The ABA claims that it tries to ensure the banking system can continue to deliver the benefits of competition to Australian banking customers.

In practice the ABA works to ensure that the banking industry views are put forward when governments determine policy or legislation. Many areas of Commonwealth and State law and in some cases international law, impact upon the commercial interests of Australian banks. The Australian Competition and Consumer Commission (ACCC), the Australian Securities and Investments Commission (ASIC), the Australian Prudential Regulation Authority (APRA) and the Reserve Bank of Australia (RBA) regulate banks.

With the active participation of the member banks, the ABA works to foster an environment in which financial services are properly appreciated and allowed to prosper. In conveying the industry's views, the ABA works with the Commonwealth, State and Territory Governments, the regulators, other industry associations, the community, community groups and the media.

The ABA has issued the Code of Banking Practice, which is a voluntary code of conduct that sets standards of good banking practice for banks to follow when dealing with persons who are, or who may become, individual and small business customers and their guarantors. This COBP is reviewed periodically and updated by a professional external consultant. The Code establishes the banking industry's key commitments and obligations to customers on standards of practice, disclosure and principles of conduct for banking services. When a bank adopts the Code, it becomes a binding agreement between the individual customer and the bank.

Although the Australian Bankers' Association instituted the Code, an independent body administers compliance. The Code Compliance Monitoring Committee (CCMC) was established to ensure that banks that have adopted the COBP meet the standards of good practice set out in the Code. The Committee investigates complaints that the Code has been breached. CCMC also monitors bank compliance with the Code through compliance activities such as mystery shopping, surveys and compliance visits.

However CCMC does not get involved in financial loss. If a complaint against a bank includes a claim for financial loss, the Banking and Financial Services Division of the Financial Services Ombudsman (FOS) would consider the complaint. The FOS may also be able to consider other complaints that the CCMC cannot look at, for example, where the bank being complained about has not adopted the Code. The Financial Services Ombudsman endeavours to independently and impartially resolve disputes between consumers, including some small businesses, and participating financial services providers. The FOS independent dispute resolution processes cover complaints about financial services including banking, credit, loans, general insurance, life insurance, financial planning, investments, stock broking, managed funds and pooled superannuation trusts.

The CCMC can look at serious and systemic breaches of the Code. Such complaints can also be reported to the Australian Securities & Investments Commission (ASIC), whose role will be discussed in the section on regulators.

Though both the HKAB and the ABA are industry associations representing their member banks, the ABA is portrayed as very different from the HKAB, which takes active business decisions. In the past, the HKAB fixed interest rates and, though market forces now set the rates, it continues to carry significant influence. Moreover, the three permanent members of the HKAB are the official issuers of the currency and the official note clearing banks. The ABA confines itself to formulating bank industry policy particularly in relation to regulations and compliance thereof. It avoids matters involving competition among the banks because it acts as an advocate for the entire industry.[2] In certain ways there is a commonality because Australia is characterized by four major trading banks that are clearly larger than any other bank in the country, whereas Hong Kong is dominated by three leading banks, but the key difference is that the latter banks conduct specific monetary roles on behalf of the government treasury in addition to their commercial functions and they maintain positions as rotating permanent chairmen of the HKAB. One would therefore consider that the HKAB and the HKMA have a symbiotic relationship, whereas the ABA functions more as an industry advocate vis-à-vis the RBA.

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[2] Transcript AU 2.

B. Regulation in Hong Kong

B. 1. Financial Crises in Retrospect

In order to understand the attitudes and practices of banks and regulators it is especially useful to comprehend the environment in which they have operated and to recall the highly significant events that have made their imprint on Hong Kong. Without delving into the original history of the establishment of the colony by entrepreneurial traders from the British Empire, one only needs to recall historical episodes such as the Chinese Civil War ending in the establishment of the Communist Peoples Republic of China in 1949, and the Mao-inspired Cultural Revolution of the 1960s characterised by upheaval and persecution, which resulted in large-scale migration to Hong Kong and Taiwan. But for the banks and the people living in the territories the initial modern premonition of the turbulence that would soon test the resilience of Hong Kong was the Thatcher declaration of 19 December 1984 when the British Prime Minister Margaret Thatcher announced that Great Britain would be handing over Hong Kong back to China in 1997 as part of its mutual agreement.[3] This was the impetus behind the frenetic panic-driven foreign exchange trading immediately after that announcement that saw the HK$ falling to its historical low and resulting in the establishment of a linked exchange system with the US dollar.

Why was there such a panic? Many residents had fled the centrally planned communist regime in China for the laissez-faire milieu of Hong Kong, some of them becoming very prosperous, many attaining respectable, comfortable professional

[3] BBC News, "1984: Britain Signs over Hong Kong to China," (BBC, 1984), http://news.bbc.co.uk/onthisday/hi/dates/stories/december/19/newsid_2538000/857.stm (accessed 29 April 2009).

status, with the average folk relishing the newly gained freedom, and they then feared all their affluence and independence would be lost once Hong Kong was returned to China, from which they and their parents had struggled to flee.

Therefore the initial reaction was to sell the local currency in order to buy foreign currency. The second and more long-lasting one was that the residents applied for, and received in many cases, permission to migrate to foreign countries such as Canada, Australia, and Britain.

When the handover eventually came in 1997, there was also a mad rush to sell property because these migrants wished to dispose of their assets so they could buy new homes in their new countries. A city that had experienced spectacular growth in property prices saw the real estate sector collapse by 70% over the next several years. Such a dramatic downturn was due to a loss of trust by the people of Hong Kong in the sustainability of the institutions and the rule of law that had safeguarded the freedom to which they had grown accustomed. China had given assurance of having one country but maintaining two systems, that is, allowing the capitalistic money-oriented economy to continue unfettered within the communist state, but the Hong Kong residents had misgivings about this promise. The succeeding years would prove to be the true test.

The freefall in property prices and the loss of trust by the residents wrought severe repercussions on the banks and the financial stability of the former colony, thus necessitating institutional restructuring and upgrading of the regulatory framework in order to cope with the unprecedented systemic stresses.

Just as the former colony struggled to recover from this crisis of confidence, Hong Kong was afflicted in early 2003 by an unexpected SARS (Severe Acute

Respiratory Syndrome) epidemic, which was transported from mainland China because of the extensive trade and commerce. SARS was a rare form of pneumonia caused by a coronavirus resembling that responsible for the common cold but was different because it was deadly, originated from contact with contaminated animals, and was not spread in the air but through contact with infected persons. This was a blow to all segments of the economy as factories and commercial offices sent workers home whenever employees were diagnosed with the disease. The impact was ferocious on tourism as all travel dried up overnight, and unemployment in the tourism, air transport, hospitality, restaurant, and retail sectors soared to an all-time high of 7.8% in the period of February – April 2003. All business enterprises suffered because production, sales, and profitability plummeted as the disease spread like bush fires.

The banking system had to struggle anew with this menacing onslaught, which struck at the whole corporate establishment as well as the working classes, the professionals, and the business elite. An entire branch of one bank had to close down when it was discovered that one employee was infected with the deadly virus. The story of the past decade reveals the amazing crucible that has shaped the ethos of the present-day banks of that city. The banking edifice of any other country might easily have collapsed under these circumstances.

B. 2. The Hong Kong Monetary Authority

In response to the numerous financial crises and in preparation for the hand-over, the Hong Kong Monetary Authority (HKMA) was established on 1 April 1993 as Hong Kong's central banking institution by merging the Office of the Exchange Fund with the Office of the Commissioner of Banking. This was made possible by legislative amendments to the Exchange Fund Ordinance in 1992 empowering the Financial Secretary to appoint a Monetary Authority. What makes this institution unique is that the Exchange Fund Ordinance – Section 5A specifically states that "The Financial Secretary shall appoint a *person*[4] to be the Monetary Authority on such terms and conditions as he thinks fit."[5] Thus the Office of the Monetary Authority is known as the HKMA, and the Monetary Authority as the Chief Executive of the HKMA.

The HKMA has four main functions: maintaining the stability of the Hong Kong dollar; promoting the safety of Hong Kong's banking system; managing Hong Kong's official reserves; and maintaining and developing Hong Kong's financial infrastructure.[6] The Banking Ordinance provides the Monetary Authority with the responsibility and powers for regulating and supervising banking business and the business of taking deposits. The HKMA's Supervisory Policy Manual states that:

> The HKMA's primary function under the Banking Ordinance is to promote stability within the Hong Kong banking system. Good and ethical banking practices are essential for safeguarding depositors' interests, maintaining the stability of the banking system and preserving Hong Kong's reputation as an international financial centre.
> The HKMA believes that it is consistent with these functions to require AIs (approved institutions) to promote a sound moral culture within their organisations and to develop a set of ethical standards and values to which their staff are expected to adhere. This can be done by means of establishing a Code of Conduct and having a system in place to enforce it.[7]

It is significant that the Monetary Authority explicitly declares the need for morality to be practised by individuals and ethical conduct to be institutionally established in

[4] Italics added.
[5] Hong Kong Legislature, "Exchange Fund Ordinance," in *Chapter 66* (Hong Kong: 1997), http://www.hklii.org/hk/legis/en/ord/66/ (accessed 15 November 2006).
[6] HKMA, "An Introduction to the Hong Kong Monetary Authority," ed. Hong Kong Monetary Authority (Hong Kong: 2006), http://www.info.gov.hk/hkma/index.htm (accessed 15 November 2006).
[7] ———, "Supervisor Policy Manual," ed. Hong Kong Monetary Authority (Hong Kong: 2006), http://www.info.gov.hk/hkma/eng/bank/spma/index.htm (accessed 9 March 2007).

the banking system because this has elicited a positive response from the banks. Considering that countless individuals maintain deposits with banks, the protection of those depositors can only be ensured through principled and fair treatment by the banks. One could infer that the previous crises that afflicted Hong Kong provided the incentive for this affirmation of morality.

The Chief Executive appears particularly concerned about integrity as he wrote: "The integrity of the financial system is too important for us to allow it to be undermined: effective regulation and robust systems are essential."[8] One interprets this to unequivocally mean that the Chief Executive considers regulation as necessary for maintaining integrity, which is indispensable for financial intermediation to effectively support economic growth especially in an international financial centre like Hong Kong with its global ramifications on investors and fund-raising issuers worldwide.

The Authority rightly expressed apprehension about the "deep-rooted dilemma between the public interest in ensuring effective financial intermediation that promotes the general well-being of the community and the private interest of financial intermediaries in maximising profits."[9] He sees the key role of a financial system as that of a conduit between sources and users of funds, with providers or depositors accepting the credit risk of the banks and the latter exposed to the credit risk of the borrowers. As remuneration for their services and the risks of intermediation the banks earn a net interest margin, or the difference between what they pay depositors and what they charge borrowers.

[8] Joseph Yam, "The Integrity of the Financial System," ed. Hong Kong Monetary Authority (Hong Kong: 2006), http://www.info.gov.hk/hkma/index.htm (accessed 5 April 2007).
[9] ———, "A Deep-Rooted Dilemma," ed. Hong Kong Monetary Authority (Hong Kong: 2006), http://www.info.gov.hk/hkma/index.htm (accessed 10 April 2007).

An effective financial system is one that gives a high rate of return to those saving or investing money, and a low cost of funds for those raising money. But clearly for the intermediaries to play their specialised role effectively, they need to have the correct incentive to do so, and this means a reasonable level of remuneration for them, in terms of profits for the financial institutions and pay for those working in them. The HKMA said: "*To ensure reasonableness, policymakers often, and rightly, rely on the competitive forces of the market.*"[10] (Italics added)

The HKMA realizes that a totally free market is not always feasible because the role of intermediation can only be entrusted to institutions with high integrity, thus necessitating banking supervision and regulations. At this point in time there was already ethical concern with selfish interests in compensation that needed to be curbed.

A free market also implies a somewhat protected mandate for the intermediaries that may be further strengthened through the advocacy of industry associations. Banks vigorously pursue self-interested, profit-maximising objectives. Therefore the more successful the banks are in their corporate role, which is measured by the profits they make, one can argue, the less effective is the financial system in financial intermediation. According to the Hong Kong Monetary Authority, this is the deep-rooted dilemma often faced by policy-makers.[11]

While the HKMA leaves the relationships between banks and customers in the hands of the banks as befits a free market, it upholds the ethical value of transparency and disclosure in order to grant an adequate degree of protection for individual clients and lessen the need for supervisors and regulators to get involved. The HKMA sets

[10] Ibid.
[11] Ibid.

the standards and occasionally promulgates statutory guidelines. It expects its constituent banks to comport themselves according to 'best practice' norms.

Although not a consumer rights advocate per se, the Authority in actively promoting greater competition within the banking system, had started to curb the powers of the HKAB cartel in the 1990s and after seven years successfully eliminated interest rate fixing, which brought positive benefits to both depositors and borrowers alike. During the cartel regime the net interest margin had ranged from 2 to 3%, which in 2006 fell to 1.4 to 1.5%, which was evidence of the high efficiency of the banking system.

While subscribing to the conviction that competition stimulates efficiency, the Authority says that regulators must ensure that competition does not reach the point of eroding profitability to such an extent that it pushes financial intermediaries into irresponsible behaviour that eventually undermines the stability and integrity of the financial system. The Chief Executive of the HKMA stated: "*improper behaviour ...is categorically unacceptable.*"[12]

The Authority is of the opinion that regulators cannot prevent all crime or unethical behaviour; it promulgates guidelines and rules, statutory or otherwise, but expects the private sector to act without the supervisors reviewing every transaction. The Authority thus encourages transparency and investor education. Where necessary, it promotes investor protection measures, such as the requirement for deposit insurance introduced in 2006. The motive behind deposit insurance could be interpreted as a Kantian categorical imperative of treating all bank depositors as persons but it could also be perceived as utilitarian in the sense that it sought to

[12] Ibid.

protect as many small depositors as possible and implant confidence among them in the banking system.

B. 2.1 Credit Cards

The proliferation of credit cards was due to competition and in the HKMA's view possibly good for cardholders who obtain rebates and are able to earn awards with their usage, but the worry is about the potentially reckless issuance of cards to individuals who are not in a position to borrow or service their liabilities, for instance students. The Authority's concern is that all banks conduct business prudently or otherwise it could intervene. But non-bank institutions, which are beyond the scope of banking regulation, also issue credit cards so the HKMA normally prefers to allow the market to instil discipline. Its main anxiety is over risk management, that banks are issuing credit cards to the right people.[13]

The Monetary Authority has witnessed scores of problems that surfaced during the period of economic crises and the devastating SARS epidemic. In the worst case scenarios credit card borrowers amassed debt exceeding 40 times their net income, leading to an extraordinary bankruptcy rate. The HKMA identified the need for sharing credit information so that every lender could be aware of the overall level of indebtedness of each potential borrower or credit card applicant. In its role as supervisor the HKMA wished to ensure that banks take prudent risk and therefore encouraged the establishment of a credit bureau, which is owned by the private sector.[14] Since then, loan losses have dropped to comfortable levels. Credit cards are a profitable source of income but not a big part of overall earnings.

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[13] Transcript HK 5.
[14] Ibid.

B. 2.2 Housing Loans

The mortgage loan segment has been a major concern for the HKMA because it is the largest component of banking assets. The Authority is therefore particularly keen to make certain that banks proceed cautiously with granting mortgage loans – for both commercial and residential purposes. It has therefore deemed it necessary to promote prudent practices, such as setting a loan value ratio of 70%, a debt service ratio of 50%, and the enactment of non-performing loan classification. These guidelines are far more stringent than those observed in America over at least the last ten years.

The Authority does not feel that banks were responsible for driving up housing prices because banks are in the business of taking risk and providing financing to whoever is creditworthy. In arriving at decisions banks have to evaluate the creditworthiness of prospective borrowers and the quality of underlying assets. Banks can choose to act counter-cyclically and help to dampen speculation. As displayed at the height of the property boom banks voluntarily reduced their loan valuations ratios to 60%, even 50% in some instances, especially for luxury housing that tended to be more volatile.

B. 2.3 Negative Equity Problem

There are two sides to this problem, the first one relating to the anguish of individuals who suddenly become aware of their negative equity position, that the current value of their property has plunged vis-à-vis the amount of the loan they still have to repay. This situation, which is upsetting by itself, could be aggravated if the interest rates soar or the borrowers lose their jobs, which could impair their capacity to repay their obligations. The other side corresponds to the position of the lenders who discover that the collateral assigned to them has deteriorated. As Chapter 6 will point out, this is precisely what occurred in the sub-prime crisis that erupted in America in 2007. "As banking supervisor, the HKMA's concern has to be the likely significance of negative-equity mortgages for the quality of the loan book of the banks."[15]

It is due to this apprehension that the Authority prescribed a loan valuation ratio of 70% for residential mortgage financing. Adherence to this guideline made it possible for banks to weather the storm. It was also not a common practice for banks to demand additional collateral on performing mortgage loans of owner-occupiers, who were making regular timely repayments.[16]

A look at the actual levels of valuation of residential mortgage loans (RML) reveals a peak of 105,697 cases in negative equity amounting to HK$ 165 billion representing 22% of all RMLs but 31% of total value, yet resulting in a delinquency ration of only 2.28%. By December 2006 the circumstances were substantially improved with 8,444 cases with HK$ 14 billion outstanding or 3% of all RMLs. The delinquency ratio was down to a low level of 1.26%. What is extraordinary is that even at the height of the negative equity problem the delinquency ratio always remained at a respectable level. These levels of negative equity and delinquencies are depicted in the table below.

HONG KONG NEGATIVE EQUITY & DELINQUENCY IN RESIDENTIAL MORTGAGE LOANS 2001 - 2006

Negative equity RMLs (end of period figures)	Cases (% of total RMLs)	Value (% of total RMLs)	Delinquency ratio
Sept. 2001 (1st available position)	65,000 (14%)	$127 billion (23%)	Not available
Jun 2002 (peak of delinquency ratio)	68,252 (14%)		
Jun 2003 (peak cases & value)	105,697 (22%)	$165 billion (31%)	2.28%
Dec 2006 (latest available position)	8,444 (2%)	$14 billion (3%)	1.26%

[15] Joseph Yam, "Mortgage Loans in Negative Equity," ed. Hong Kong Monetary Authority (Hong Kong: 2006), http://www.info.gov.hk/hkma/index.htm (accessed 12 April 2007).
[16] Email to JS Villa, HKMA, 13 April 2007.

B. 2.4 Supervisory Stance

The Hong Kong Monetary Authority prefers the term supervision to regulation in describing its role. The HKMA has progressed from a posture of prudential supervision to one where it defines a policy framework within which financial intermediaries operate and are encouraged to adopt sensible risk management tools. In carrying out corporate finance, foreign exchange trading and securities dealing, the banks are expected to utilise appropriate risk management tools to guard against credit risk, operational risk, market risk, interest rate risk, exchange risk, legal risk, and reputational risk. In the view of the HKMA the reputation of an institution would be damaged if it provided financing to a project or a borrower that destroyed the environment or harmed the community, so it would be unwise to back such a scheme. Likewise the HKMA expects banks to adopt best market practices and institute codes of conduct and procedures that discourage fraudulent trading among dealers. The Authority does not discourage banks from taking risks, but they must have effective mechanisms in place to manage these risks.

Rather than acting as a consumer advocate, the HKMA adopts the stance that fees and charges are commercial decisions of banks. It defines its role as one of "ensuring transparency and sufficient competition in the market so that consumers can make their own decisions."[17] This comment encapsulates the laissez-faire character of the Hong Kong banking environment

B. 3. Attitude of Banks towards HKMA

The bankers expressed the sentiment that the banking industry in Hong Kong is over-regulated with the HKMA imposing too many detailed guidelines that require banks to submit excessive quantities of returns, which are a cost burden. The banks would

[17] Ibid.

prefer a risk-based[18] approach that attempts to avert or mitigate risks and ensures a level playing field for all market players, rather than the current system in which the HKMA is perceived as regulating all activities. Moreover, since many banks in Hong Kong are engaged in securities activities, they are also subject to the supervision of the Securities and Futures Commission, which is allegedly very tough on banks.

There is a feeling among financial institutions that industry self-regulation through the Hong Kong Association of Banks is quite effective and that good banking practices are in place, but there is also an impression that the regulators do not have a sufficiently comfortable level of trust in the banks. While comments from bankers abound that much pressure is imposed by the HKMA in the form of costly compliance and additional reporting, bankers nevertheless acknowledge that the HKMA has performed well, engaged in dialogue with the banks, and through the HKAB encouraged self-regulation with the espousal of the Code of Banking Practice.

There is the observation that unlike former days the HKMA has become much more pro-active as a result of several major directives emanating from international regulators such as Basel II relating to bank risk, Sarbanes-Oxley on corrupt practices, and anti-money-laundering decrees. The latter, for instance, necessitated the acquisition by banks of expensive software, which was not previously utilised.

It has been remarked that the Hong Kong Monetary Authority is one of the most enlightened regulators in the world, with strong leadership at the top. There has been reference to the HKMA as more similar to the UK and European models than the American one, the latter having an approach of 'comply or perish', and the HKMA a technique of 'comply or explain.' In other words, the HKMA is prepared to

[18] Oddly enough this is what the HKMA asserts it likewise wants, but the difference is that banks seem to be more interested in a 'level playing field' than protecting themselves against various risks.

listen to a bank's explanation for non-compliance and will not automatically impose penalties; it might well accept the clarification. There is therefore a view that the HKMA is a 'world class' regulator.[19]

There is general agreement that the regulatory, compliance, and legal environment of the banking system has become much more rigorous than five years ago. Banks have to ensure that they operate soundly, are well capitalized, take the right risks and manage them well in order to protect the customers and depositors. The costs have been enormous for banks, but the institutions are more robust and risk-free than five to ten years ago.

Nevertheless, professionals in the field maintain that even in the absence of regulations the banking history of Hong Kong has demonstrated that banks have typically acted in a very responsible manner and have displayed a high level of natural integrity. There is a belief that the business environment here is good where people operate on the basis of trust. There is a claim for a high level of ethics among banks in Hong Kong. Reference was made to only one instance of serious misconduct that occurred in a major foreign-owned bank in the past decade.[20]

There is the view that the cooperation between the HKMA and the banks is one of the main factors that explain why Hong Kong did not collapse despite all the catastrophes that battered it. Communication between the HKMA and the banks is deemed very good and has engendered a sound banking system. Similarly the HKAB is regarded as performing an important role in coordinating with the HKMA on behalf of all the banks. An example cited is the synchronization of deposit insurance fees for the different levels of banks.

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[19] Transcript HK 3.
[20] Transcript HK 5.

Top bankers accept that regulations are enacted in order to foster discipline but believe more self-regulation should be encouraged with reliance on guidelines in lieu of austere regulations. The Dragon CEO argues that the better-managed banks should be granted more flexibility based on their own self-assessment.[21] The leading banks believe they would behave the same way even in the absence of regulations because their internal standards exceed those required in regulations.

They contrast the situation in China, where corruption is rife, with that in Hong Kong, where it is avoided. The Hong Kong bankers attribute this to several factors that are positive in Hong Kong, namely: a high level of education, a well-defined legal system to which people adhere, a high standard of living, a well-paid and disciplined police force. They allude to a lack of checks and balance in China unlike Hong Kong, where the establishment of the Independent Commission against Corruption more than thirty years ago is regarded a highly effective measure that provides equal recourse to the law for everyone. The free press is another essential ingredient.

Some top bankers remark that regulations are probably necessary in developing areas such as Latin America in order to instil discipline but their own global institutions have performed very well in emerging markets. Because of their experience in such markets one leading bank avers it has taken the initiative towards more self-regulation, that is, of setting standards according to its moral values.

[21] Transcript HK 8.

C. Regulation in Australia

C. 1. Deregulation, Banking Crisis, and Recession

The Australian financial system has undergone several major adjustments over the past sixty years, with the period from the Second World War until the late 1970s characterized by stringent regulations on trading and savings banks such as interest rate ceilings and asset ratio requirements. As Fitzgibbons wrote, a new breed of financial institutions developed during this period:

> However, during the 1950s and 1960s, a number of NBFIs (non-bank financial institutions) emerged outside the regulated banking sector, including finance companies, merchant banks, building societies and credit unions, and began to challenge the dominance of the banks.[22]

These NBFIs were not subject to the same degree of controls affecting the banks and hence offered new competition. These new institutions arose in response to increased demand for financial services driven by economic growth.

Although the two-tier financial structure meant that banks had to operate under strict rules, they enjoyed numerous benefits. As Amanda Fitzgibbons explains:

> Many financial regulations conferred significant advantages upon the banks. Exclusive access to LLR (lender of last resort) facilities and an implied guarantee in case of failure gave the banks an unsurpassed reputation for safety and stability that attracted many customers. Regulations gave the banks a collective monopoly over cheque payments services and foreign exchange transactions: the latter was particularly valuable, as it was highly profitable and the Reserve Bank bore all the risks. Entry regulations prevented competition from foreign banks and ensured the domestic banks' semi-monopolistic positions. The burden of controlled interest rates on loans was offset by controls on deposit interest rates and the prohibition of interest payments on current accounts, which provided the banks with a large source of low-cost funds.[23]

[22] Amanda Fitzgibbons, "The Financial Sector and Deregulation in Australia: Drivers of Reform or Reluctant Followers?," *Accounting, Business & Financial History* 16, no. 3 (2006): p. 372.
[23] Ibid.: p. 374.

The banking sector therefore preferred to live under a regulatory regime rather than admit entry of new and stronger bank competitors. Yet the forces of economic progress and international markets started to clamour for change and deregulation, and in January 1979 the Campbell Committee was established to conduct an inquiry into the conditions of the Australian financial system. Submissions were requested from the Australian Bankers' Association, which acted as the banking industry's advocate and, at that time, was staffed by economists who backed ideas of economic liberalism and free markets and who therefore argued in favour of deregulation; bank economists who came from a similar academic training were likewise highly supportive.[24]

However, the bankers themselves did not share this view and were resistant to change. They were especially fearful of the entry of foreign banks that might come to Australia once deregulation was enacted. In countering such sentiments the bank economists argued that, if the banks wanted to expand overseas, they had to accept the principle of reciprocity and allow foreign banks to operate in Australia. Even while desiring international expansion, the bankers wanted foreign bank entry to be delayed in order to be better prepared.

The NBFIs were lukewarm towards deregulation because the current restrictive regime created a niche for them. As pragmatists, they acknowledged that deregulation was unavoidable and so they sought equality with the banks, which in turn attempted to exclude foreign institutions and retain their oligopolistic powers over the payments system and foreign exchange.[25]

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[24] This analysis of the rationale behind deregulation was developed by Fitzgibbons.

[25] Fitzgibbons, "The Financial Sector and Deregulation in Australia: Drivers of Reform or Reluctant Followers?," p. 385.

The banking sector and the NBFIs submitted their respective recommendations to the Campbell Committee with each group seeking partial and selective deregulation to suit its own respective vested interests. For instance, credit unions and building societies resisted foreign bank entry but insurance companies were favourably disposed.

While the Inquiry was underway, the financial institutions embarked on stratagems to prepare for the inevitable onset of deregulation, which they viewed with trepidation. The banks believed that they needed to grow bigger in order to meet foreign competition, so a spate of mergers ensued. In June 1981 the Bank of New South Wales, the oldest bank in the country, merged with the Victoria-based Commercial Bank of Australia to form Westpac. During the same timeframe the National Bank of Australasia merged with the Commercial Banking Company of Sydney with the resulting entity named National Bank of Australia. In addition to mergers these enlarged banks went on an expansion programme to acquire other financial subsidiaries such as merchant banks and finance companies.

In November 1981 the Campbell Committee submitted its final recommendations to the parliament that included abolishment of interest rate restraints, floating of the Australian dollar, and allowing entry of new foreign and domestic institutions into the Australian banking system. Westpac faced these new challenges with heightened vigour.[26]

In her book on Westpac, Carew narrates how Australia's oldest bank endeavoured to pursue growth through aggressive lending, acquisition of new businesses, and establishment of a global network.[27] During a period of less than six

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[26] Edna Carew, *Westpac: The Bank That Broke the Bank* (Sydney: Doubleday, 1997), p. 19.
[27] Ibid.

years Westpac transformed itself from the leading Australian bank to the epitome of financial disaster. It launched finance companies and merchant banks, which had scant central control and sometimes competed with each other and provided loans to the same corporate customers; it embarked heavily in property financing and development and its various subsidiaries wound up becoming substantial property owners. For the first time in its long history the bank hired outsiders in senior management positions to propel the growth in global markets and in new financial product areas such as foreign exchange trading and treasury products. The incumbent bankers who had spent their entire careers in Westpac unsurprisingly resented these newcomers, and this cultural clash prevented integration that could have fostered genuine dialogue.

In January 1983 the Australian Treasurer declared that the government would allow the establishment of ten new banks, including foreign-owned ones. The newly elected Labor government in March of that year formed the Martin Group to review the Campbell recommendations; in February 1984 the Martin Review Group gave its support to maintaining deregulation as well as entry of new, including foreign, banks.[28] The government followed the recommendations and in 1985 approved the licensing of sixteen new foreign banks, far more than initially proposed by the Campbell Committee.

The over-reaction to deregulation by the existing banks as well as the onslaught of the new entrants in the 1980s created the circumstances that would lead to the worst losses in the Australian banking industry in nearly a century.

> Deregulation in the mid 1980s intensified competition and the desire by institutions to grow their balance sheets rapidly. This took place in an environment in which asset prices, particularly commercial property prices, were

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[28] ———, *Fast Money 4* (St. Leonards, NSW: Allen & Unwin, 1998).

increasing quickly, and credit assessment procedures in many financial institutions had not adjusted to the new liberalised environment. The result was extremely strong credit growth secured against increasingly overvalued commercial property. In 1989, the combination of high interest rates and a softening of the commercial property market exposed the poor credit quality of some of the most risky loans. Then, as the economy went into recession and the decline in property prices accelerated, more broadly based credit quality problems became evident...[29]

Westpac suffered heavy losses but as a group the banks owned by state governments and foreign banks lost the most because they were the most relentless in the pursuit of market share. Supervision of the state banks was made difficult by the technicality that the Reserve Bank of Australia (RBA) did not have formal legal powers over licensing, "even though the state institutions had given formal voluntary undertakings to meet the Reserve Bank's prudential standards."[30]

While public trust in financial institutions was shaken by the huge losses and runs on smaller entities, overall confidence was not eroded because of public sector intervention. The state governments ensured that no depositors lost their deposits while the foreign banks replenished the capital of their Australian subsidiaries. The depositors of the Big Four were never in danger of losing their deposits in the 1990s.

While the 1980s could be described as the era of corporate financing extravagance, the 1990s ushered in a significant financial development, the escalation of Australian *household indebtedness.* As RBA economists noted in a conference paper, the proportion of household debt to household disposable income nearly doubled over the decade, "rising from 54 per cent in 1990 to almost 100 per cent at the end of 1999...Most of the additional debt was used to purchase residential

[29] Marianne Gizycki and Philip Lowe, "The Australian Financial System in the 1990s," in *The Australian Economy in the 1990s* (Reserve Bank of Australia Conference: Reserve Bank of Australia, 2000), http://www.rba.gov.au/PublicationsAndResearch/Conferences/2000/GizyckiLowe.pdf, p. 183 (accessed 15 February 09).
[30] Ibid., p. 186.

estate."[31] A key reason for the emergence of households as a major market segment was the breathing space needed by corporations to wind down their excessive loans and acquisitions. The loan losses of banks from corporate finance propelled them into retail banking.

Accompanying the increase in household debt was the shift of household savings away from traditional bank deposits to market-oriented investments. This had a profound effect in the restructuring of the balance sheets of banks.

> The combination of strong credit growth and subdued growth in domestic deposits has led financial institutions to rely increasingly on wholesale markets for funding, largely through debt securities. Given the relative lack of domestic savings, many of these securities have been issued to non-residents.[32]

This dependence on international funding would subsequently impact Australian banks adversely as liquidity tightened during the global financial crisis.

Deregulation brought competition to the market for residential mortgages, where the RBA reported "the margin between the standard mortgage rate and the cash rate fell from a historically high 4-1/4 percentage points in 1992/93 to around 1-3/4 percentage points in 1999."[33] Although the mortgage brokers relied on banks for initial funding, they later turned to securitsation of mortgage assets and were able to lower margins on their loans without worrying about the profitability of existing loans.

In the financial product of credit cards, competition was also fierce, but the strategy was a robust attempt on the part of credit card issuers to stimulate card usage through various loyalty reward programmes rather than a cut in lending margins,

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[31] Ibid.
[32] Ibid., p. 189.
[33] Ibid., p. 194.

which succeeded in driving a "five-fold increase in the number of credit card transactions over the decade, and a trebling since 1995."[34] Competition in this case did not offer card customers financial benefits but creative inducement schemes to earn frequent flyer mileage or loyalty points with other service providers.

Despite competition banking business became more concentrated among the top five banks and their average return on equity remained unchanged. A noteworthy contributor to profitability was the growth of non-interest income, which was primarily *fee income* on services provided to households. According to RBA economist Gizycki, "the most notable examples are the introduction of mortgage fees and account-servicing fees...whereas in 1990 such fees rarely existed."[35]

There are several observations one can make about financial liberalization in Australia during the 1980s. Firstly, many new financial institutions were established, with some of the largest international groups setting up branches or subsidiaries. Secondly, the push to lower interest rate margins came from newcomers rather than from the major local banks that had the biggest market shares. Thirdly, zealous speculation created a property bubble that caused financial losses at numerous banks, thus resulting in the failure of several institutions and concentration of assets among the leading five banks. Fourthly, household debt emerged as a significant growth factor. Fifthly, banks became progressively more reliant on funding through asset-backed securities and the use of derivatives in international financial markets. Finally, the structure of prudential supervision and regulation required adjustment and strengthening to cope with the sea change brought about by deregulation.

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[34] Ibid., p. 196.
[35] Ibid., p. 197.

C. 2. New Regulatory Model

The crisis suffered by the financial sector in the late 1980s to the early 1990s resulted from deficiencies in the risk management systems of the financial players and the prevailing regulatory structure. The immediate response in the initial half of the 1990s was the compulsion on financial institutions to upgrade their risk-management techniques, while in the latter half of the decade there was an emphasis on regulations that encouraged competition, protection of individual customers, responsiveness to financial innovation, and firmness to ensure a stable financial system.

The new measures included regular on-site bank inspections by the Reserve Bank, the enactment of guidelines on the determination of non-performing loans, assumption of responsibility by the RBA of regulation of state-owned banks, and the creation in 1992 of the Australian Financial Institutions Commission (AFIC) to supervise building societies and credit unions.[36] AFIC brought disjointed State systems under unified national regulation.

After instigating much of the necessary enhancement to address the earlier problems, the Commonwealth Government created the Wallis Inquiry in 1996 to undertake the first comprehensive assessment of the Australian financial system since the Campbell Inquiry in the late 1970s. The Wallis Committee was tasked with evaluating the results of deregulation since the 1980s, examining the elements of transformation in the industry, and proposing a regulatory structure ideally suited for efficiency, flexibility, and competition in the financial system.[37] In its final report of

[36] Jeffrey Carmichael, "Apra: Some Reflections on Where We Have Been and Where We Are Heading," in *Australian Institute of Credit Union Management Conference* (1998), http://www.apra.gov.au/speeches/98_05.cfm (accessed 20 February 2009).
[37] Ibid.

March 1997 the Wallis Inquiry recommended a significant reorganization of financial regulation.

> Responsibility for the prudential supervision of banks, building societies, credit unions, insurance and superannuation funds was assigned to the Australian Prudential Regulation Authority (APRA), which commenced operations in July 1998. This brought to an end the Reserve Bank's role in bank supervision. Responsibility for market conduct and disclosure in the financial sector was assigned to the Australian Securities and Investments Commission (ASIC), which was also given responsibility for the enforcement and administration of the Corporations Law and consumer protection across the financial system. The Reserve Bank retained responsibility for monetary policy and the maintenance of financial system stability. In addition, a Payments System Board was established within the Reserve Bank with responsibility to promote safety, competition and efficiency within the payments system.[38]

The remarks in a speech of the inaugural Chairman of APRA, Jeffrey Carmichael, are worth noting:

> It is universally agreed that the primary rationale for regulation is market failure. There is a widely held myth that Western economies are built on unfettered free markets – on laissez faire. The reality is that all markets fail, and they fail for a variety of reasons: Private enterprise only works where regulation corrects market failure.[39]

Regulations, of course, are simply rules of behaviour. As a totality, regulation attempts to establish a legal and ethical framework within which commerce can flourish to the mutual benefit of all involved. The ideal regulatory system encourages competition, but does so in a way that encourages honesty and fairness.[40] According to this view, market failures can result from a number of factors, which include monopolistic or anti-competitive behaviour, consumer exploitation and market manipulation, the lack of prudence in the structure of financial products, and the

[38] Gizycki and Lowe, "The Australian Financial System in the 1990s," p. 203.
[39] Jeffrey Carmichael, "Australia's New Regulatory Model," in *Forex 1998* (Asia Pacific Conference - ACI Assembly: 1998), http://www.apra.gov.au/speeches/98_14.cfm (accessed 20 February 2009).
[40] Ibid.

breakdown of trust in and among financial institutions. As pointed out earlier, the advent of deregulation motivated the existing banks to attempt to strengthen their bastions through pre-emptive acquisitions and unbridled expansion. They also sought to manipulate markets without concern for individual customers. In the process they extended huge loans funding a property bubble that eventually burst and inflicted sizeable losses on several institutions. Bank runs were a natural consequence. Such were the conclusions reached by the Wallis Inquiry that effected the rearrangement of financial regulations in Australia. One would agree this coordinated approach was the appropriate step in addressing the multi-fold risks that could cause market failures.

C. 3. Attitude of Australian Banks Towards Regulators

The attitude among banks appears to be one of resignation and forbearance. Though they claim to have good relations with regulators, credit unions contend that regulations are burdensome because they are much smaller than banks and do not have as many support staff to maintain compliance. Among banks there is a sentiment that regulations stifle innovation.

Bankers feel that there is a need for a balance between protection of the community and efficient functioning of business enterprises. They decry the unintended consequences of regulations created by the Financial Services Reform (FSR), such as a directive enacted in reaction to the fraud and eventual collapse of a well-known insurance company. There were good intentions behind the desire to establish common licensing procedures for banks and insurance companies, but the implementation has proven to be a bureaucratic nightmare because banking and insurance are extremely dissimilar businesses. Banks complain that (a) clients are now inundated with 50-60 page documents for each product because of the huge disclosure requirements, (b) banking efficiency is impaired, and (c) overzealous regulators make compliance more costly.[41]

The underlying principle is to provide disclosure and transparency so that when a customer walks into a bank he or she is expected to understand everything about a product and that it should be appropriate for what he needs. But the way this been given form under the FSR is that the bank employee hands the customer an advisory service guide, then a products disclosure statement. Those steps discharge the bank from its legal obligation, so from a compliance viewpoint it has done what it has to do. But it is questionable if the client is any wiser about what he applied for. The substance of the law is that the customer should be aware of what he is being offered. But because regulation is by nature bureaucratic and procedural, bankers argue that they end up going through the motions sometimes at the expense of the essence of the intent.

One of the difficulties under the law is that banks must have numerous disclaimers, so when a client rings a call centre (and most people usually only have simple queries), by the time all the disclaimers are announced the client wants to hang up. Many individuals claim to have this experience and find it annoying and a waste of their time. The good intent is harmed by the manner of delivery.

A number of senior executives have opined that some regulations are good, such as the Basle II Rules on capital adequacy and the anti-money-laundering directives, which have instilled a measure of discipline in banks so they now ensure

[41] Transcripts AU 2, 3.

they know their customers well and their intended use for the products. However, as Chapter 7 will show, the capital position of the world's largest banks would prove to be inadequate in the wake of the global financial crisis because innovative funding techniques allowed them to circumvent strict capital provisions in the situation of mortgage-backed securities.

There is a well-founded belief that regulators have an important role to play because trust is important. It is accepted that members of the community generally trust banks to protect their money and not embark on risky loans that jeopardize their deposits, so it is deemed appropriate to have regulations in place to make sure that the financial system is sound and serves the community. But some bankers worry that, after the Enron scandal, the manner pursued by regulators appears to be more about covering one's rear, not so much about genuinely identifying risks and dealing with them. From the perspective of banks the requisite paperwork is burdensome and distracting. The banking attitude is that well-run institutions should not have to be subjected to all these rules.

A few accept that not all banks have the proper values and contend that regulations should be directed at the firms operating at the edge of permissible conduct. They grumble that regulators spend an inordinate amount of time with the big banks and not enough time with the sub-prime lenders. They maintain that the financial operators catering to clients at the margin are committing most of the egregious violations against individuals. They admit that the large banks might occasionally get things wrong but do not mind being reprimanded, and they spend tens of millions of dollars a year in compliance. But they protest that mortgage brokers, financial planners, sub-prime lenders, and investment advisors are not regulated.[42] When the thesis subsequently turns to the story of the American sub-prime crisis, it will become evident how the situation there is especially exacerbated.

From the perspective of compliance officers it almost seems "redundant that the *government has to constantly legislate matters that are absolutely common sense."*[43] Yet two major regulations from ASIC caused great uproar among financial institutions during the twelve months prior to the interview: conflict of interest legislation and dollar disclosure.

Dollar disclosure means that if a bank teller is recommending, for example, a term deposit product for which she may receive a financial reward, she should inform the customer that she would be entitled to extra pay as a result of closing the sale. Some banks did not want customers to know that individual sales personnel were being remunerated on a volume basis. They should have been disclosing this anyway but did not, so the legislation had to be passed, and this has caused much concern.[44]

More troubling to banks is the *conflict of interest legislation* that requires financial institutions to maintain a register of conflicts of interest, which is not really a harsh demand, and to strengthen their functional segregation through more robust Chinese walls. The Bandicoot senior compliance officer said that a large bank typically owns half a dozen financial planning firms not carrying the bank's name. The bank instructs the financial planners to sell the products that it creates and also competes with them in the open market to sell the same products. When the same entity is involved in the development, distribution, and sales of the products, there is a genuine conflict. It is ethically wrong to recommend something in which one has a

[42] Transcript AU 4.
[43] Transcript AU 8.
[44] Ibid.

pecuniary interest, unless one discloses this up-front. But in Australia there has been considerable resistance.

It was alleged that in the years prior to 2003 the mores were especially bad. Managers supposedly looked at compliance from a selfish standpoint; they would ask how much the penalty would be for non-compliance and, if told that it might cost, say A$ 500,000 and the cost of implementation was A$ 1 million, they would inquire how many firms had been caught. The managers then chose to defer implementation.[45]

Some chief executives stated that their banks do not willingly break the rules and no longer operate according to a risk and reward equation because that is unethical. Yet there remain many people in some banks who continue to think in terms of balancing that equation. The ethical strife thrives because the banker is not really considering the customers; he is only thinking about himself. Bank managers are only thinking about how products translate into profitable returns for shareholders because their career orientation is towards this goal.

Every large bank says it puts the customer first, but there are those who disagree and argue that each institution is shareholder-focused. According to a compliance officer, it is absolutely paramount in large organisations to win the confidence of investment analysts and commentators.[46] After announcing their annual results, the banks undertake a two-week road show speaking to analysts at major investment houses. Superannuation funds amounted to a total of A$ 1 trillion in 2006, and investors desirous of good returns look for shares that show promise. Therefore the investors' questions relate to profitability and not whether the banks are

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[45] Ibid.
[46] Ibid.

dealing with customers in a fair and honest way. Nonetheless in 2005 one investment report commented on the poor EOS score of one large bank and questioned the long-term sustainability of the bank if employees did not like working there. It would seem this bank had to make genuine strides to listen to stakeholders other than shareholders and the investment houses.

However, one bank, which regards compliance seriously, maintains that the *focus of compliance has to be on the customers for two reasons: regulations and the reputation of the bank.*[47] The staff members have to establish the needs of customers and offer them products that best meet those needs. The bank employees should provide either general advice in terms of the range of products and their features or personal advice based on a detailed analysis of the needs.

The policies set at the top fall into two principal categories: know your customer as an overall corporate thrust and manage conflicts of interest so that employees do not put remuneration objectives ahead of customer needs. Every branch is subjected to testing for quality assurance and compliance risk. The frequency of testing depends on the risk score of the particular branch. One that had previous compliance deficiency would be visited more frequently than one that performed well. They also employ shadow shoppers pretending to be customers to check if the advice given to customers is appropriate.[48]

Two regulatory areas that banks consider highly challenging, because they are extremely difficult to detect wrongdoing, are money laundering and bribery payments. They conduct training for all employees that are tailored for those with

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[47] Transcript AU 10.
[48] Ibid.

customer contact and those in operational roles. Many locations have an anti-money laundering reporting officer.

The anti-bribery policy for well-managed banks *prohibits acceptance of bribes and facilitation payments (even if permitted by law) for reputational reasons.*[49] This is naturally difficult to enforce in countries that have acknowledged rampant corruption where Australian banks might have joint venture investments or partnerships. Australian corporate bankers state that the anti-bribery and anti-corruption policies apply in all segments of business and partnerships *over which they have control.* If one were to assume that corruption is part of a specific local culture, the challenge is to influence the behaviour of decision-makers in the other culture in situations where a bank is a minority shareholder. Since a bank might typically be a minority partner in overseas ventures one would strongly suggest that extra due diligence be conducted to guarantee effective ethical conduct.

In summary, after reviewing the circumstances that led to deregulation and the consequent reaction and behaviour of banks, followed by the Wallis Inquiry, one has to conclude that the revamping of financial regulation was necessary in order to preserve the integrity of financial markets, protect consumers, and ensure the stability of the financial system. With the introduction of new regulations one finds that there is general compliance even if some bankers express frustration. Compliance in itself does not necessarily denote ethical values in the financial institutions but rather action taken to avoid punishment and maintain reputation or public trust. One could describe compliance by banks as utilitarian.

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[49] Ibid.

CHAPTER 5. PRELIMINARY CONCLUSIONS

The previous chapters have presented and analysed the empirical research on banking conduct and attitudes in Hong Kong and Australia. There was also a review of the history behind the economic crises in those countries as well as the resultant efforts to upgrade banking regulation and the reaction of bankers to these new measures. Some preliminary conclusions would now be appropriate.

A. Diminution of Responsibility

The first preliminary conclusion is that the sense of responsibility in banks has declined to levels that have given rise to patterns of wrongful conduct. One condition that has promoted irresponsibility is the loss of focus on customers. Several bankers who were interviewed stated that it is highly important to get to know the customers and understand their needs, and one would fully agree that this is the basis of banking because the customers go to the banks with trust so the bankers should respond with considerate and reciprocal behaviour. The closest approximation to the ideal approach to customers occurs in the opening of new retail deposits when the banks' sales personnel explain the various types of products available, but even here one suspects that most institutions are more interested in legal compliance so they plaster new clients with thick brochures describing all the product features even if the latter might not truly comprehend or ever read these on their own. Handing out these booklets exonerates the bank representatives from any legal liability that could arise in the future. However, after the accounts are opened, there could be subsequent service charges of which the client might not have been aware and attempting to obtain satisfactory explanation could necessitate wasted time dealing with call centres, which now routinely handle all customer inquiries.

This loss of customer focus has led to the depersonalisation of customer relationships, whereby banking transactions are mainly handled through automated teller machines or over the internet and credit card and loan applications are processed through computerized scoring systems. One could take the view that this growing trend towards impersonal banking is a contributor to a gradual alienation of banks from the communities they are supposed to serve. Referring to the Kantian Categorical Imperative that was mentioned in Chapter 2, this denotes that banks do not treat persons as ends in themselves but rather as means of generating profits. There has been reduced accountability to customers and other stakeholders.

An example of this occurred in Australia on 8 April 2009 when the Reserve Bank of Australia reduced interest rates a further 0.25% with the expectation that banks would pass on the full amount of the reduction to their customers, but none of them did so, and one, National Australia Bank (NAB), kept the full amount to itself. The chief executives of Westpac and NAB explained that their cost of wholesale funding had risen significantly in the wake of the global financial crisis, implying that they would utilise the rate reduction to improve their profitability.

Banks proclaim their corporate social responsibility in their annual reports and special corporate responsibility reviews, which are often prominently displayed on their respective web sites, but different institutions have varying approaches. As indicated earlier, some of these appear to be good public relations exercises, though many pronouncements declare sound principles, which are laudatory if all or most of the management and employees fully accept and live according to those.

B. Departure from Fairness

The second preliminary conclusion is that the value of fairness has been eroded among bankers. In the Australian Interviews 6, 7, and 9 the top-level bankers state that they would continue to lend and offer banking facilities to legitimate businesses so long as regulations do not prohibit doing so. In other words there is a reluctance to avow any values and therefore a passive surrender of this responsibility to the state. A good example of this mode of thinking was the top banker who said:

> Here you've got a let's say the Lonely Planet Brothel down the road and they want credit card facilities. Are you going to give them credit card facilities or not? The process you'd go through is: is this legit...is this legally permissible in Victoria and if it is, is it a legitimate business? Is it conducting itself in a way that doesn't impose risks of being foreclosed...? If it is a legitimate business you have to explain to me why it was our job to say our values say we can't support that.[1]

This unwillingness to reflect upon whether certain activities are right or wrong and assert one's values is a dangerous impediment to ethical conduct and reveals a refusal to assume moral leadership. In response to a question about whether banks should install ATM cash withdrawal machines at casinos and racetrack facilities, the same senior banker said:

> ...that is quite a vexed problem because some people would say you should help to control problem gambling. Others would say that it's the individuals' right to access their money if they want it. And there's a real difficulty I think with bankers taking upon themselves to protect people from themselves and I'd have to admit to being a little on that side when it comes to capacity to repay. I do think that banks are being irresponsible...if they lend money into a situation which is going to cause or has the potential or probability of causing future difficulties because these things are never straightforward in their resolution. But once you get into the moral questions I reckon these are, first of all they're moveable issues in that today's values may not be tomorrow's. The whole point of our democratic system of government and decision-making and law formation is that you have

[1] Transcript AU 6.

> community standards from time to time which are enforceable through a process of law...that's how our system works and I can't see bankers as having any rights to change that by insisting on their own standards and values.[2]

This mindset certainly influenced this executive's perspective on all banking products and services from deposits to credit cards to mortgage loans. In other words, what was legally allowed was perfectly acceptable. Conversely what was not definitively classified as illegal was considered permissible. The banker acknowledged that it would be irresponsible to lend to someone who might have difficulties with repayment. However he also claimed that moral values are relative and bankers are not supposed to affirm their values. An ethical observer would consider this a faulty attitude because bankers are part of the community and should therefore participate in shaping the morals of society.

A major contributing factor is the cultural evolution in financial institutions where monetary rewards take precedence over principles of community service or customer satisfaction. Excessive performance-based compensation at banks has been harmful because it is a powerful stimulus behind the continuous pressure on managers and employees to aggressively push sales to clients, as clearly evidenced in the multi-million dollar bonuses paid to executives, originators, and dealers, those who either originate new debt or equity fund raising for corporate issuers or execute transactions in foreign exchange, options, or derivatives. The sales orientation is manifest even at the personal banking representative level, which is the contact point for most retail customers, who open and operate retail deposits, apply for credit cards, obtain personal and real estate mortgage loans. The majority of these bank representatives receive compensation that is commonly linked to the amount of sales and income

[2] Ibid.

they bring to the bank. While a number of banks may have instituted employee performance measures that track behavioural aspects in addition to numerical contribution, because some prominent institutional names have been afflicted with employee scams in the dealing room (where blatant fraudulent self-dealing occurred) or abuse of vulnerable customers as reported by the media, the reality is that earnings and profits are objectively quantifiable whereas behavioural assessment is adjudged as only subjectively measurable. One would therefore argue that the compensation system at most banks favour the individuals who are most aggressive and successful in delivering bottom line results. The most obvious proof of this is the massive sum of salaries and bonuses paid out to CEOs and other top executives of banks. Since nearly all the bankers speak of the significance of good examples set by senior management, the role model of personal income maximization undoubtedly permeates the entire organization.

A focus on sales growth rather than customer needs is certainly a significant reason behind the spiralling issuance of credit cards and the concomitant defaults and financial hardship of credit cardholders. Although there have been efforts by bank supervisors and consumer protection agencies (and subsequently joined by bank industry associations) to promote responsible lending, the evidence shows a steady rise in credit card issuance over many years.

A prominent area where the extreme emphasis on sales and earnings is a constant factor is the dealing room of banks where they execute trades in foreign currencies, securities, options and credit derivatives. Fraud is an enormous temptation in the dealing room. The primary means of control over dealing activities and fraud prevention is through segregation of functions and internal as well as external audit. While the desire for instant riches is usually the driving force, sometimes the motivation of the erring dealer is not personal monetary gain but egotistic glory.[3]

In both above-mentioned situations, credit cards and dealing rooms, the problems can be traced to a shift away from the customers and to a flawed compensation system. But the principal reason behind the lack of fairness and the prevalence of self-dealing is the absence of ethical leadership in these situations because senior management has relinquished primary responsibility to regulators.

A key impetus behind the growth of unfair practices in banks is the stance banks assume with regard to risk management, a critical function embedded in all banks and companies, which principally serves to protect the interests of the bank not those of its customers. It has been a widely accepted economic principle that financial returns grow with increased risk. Therefore the objective is to weigh the risks so the bank can properly mitigate against them and earn an attractive profit. For example, when banks assess credit risk factors, they are seeking to determine the probability of default of the clients, so one would argue that the emphasis is not to determine what the clients really need or what is best for the clients. Banks measure a myriad of risks, including market risk (that interest rates might move against the bank or the prices of certain assets might decline), liquidity risk (that the cost of funding for the bank might rise to such an extent that it becomes too expensive or unavailable), or sovereignty risk (that the banks might not be able to enforce its claim in a certain sovereign jurisdiction). Over several years risk management methodology has evolved into a quantitative discipline reliant on stochastic models. These mathematical models assume that all risks can be consistently predicted and

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[3] See the earlier discussion on Jerome Kerviel, a rogue dealer at the French bank Societe Generale.

mapped out in the same way that scientists forecast the activities of natural phenomena adhering to the laws of physics.

Such risk management tools enable banks to determine their pricing models. For instance, in calculating the probability and incidence of default among credit card users, banks establish interest rates for revolvers[4] as well as delinquency or penalty rates for those who miss their payments. Although there are now several financial institutions that offer varying credit cards to suit different personal needs, one observation is that interest rates on credit cards continue to be very high, thereby producing attractive profitability in this line of business. Historical experience and statistical probability of default have been factored into these rates to assure banks of profits. The individuals who are revolvers are the ones sought after by credit card issuers and yet they generally have to pay what could be considered onerous rates, even though they might not have defaulted on their obligations and continue to make regular monthly payments; in most cases, it seems their problem is simply that they have insufficient regular income to pay for recurring expenses. A few institutions claim to have started offering more reasonable terms to such individuals.

There is another set of credit cardholders who have succumbed to the sales pitch of credit card issuers, namely those who are avid buyers of consumer durables and luxury items whether or not they can afford them; they might buy on impulse or simply have extravagant taste. One view in these cases is that they should not have been offered such generous credit limits, but the risk models and the sales orientation of banks collaborated in producing the opposite results.

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[4] Those who do not or cannot pay the full outstanding balance in their account on due date and therefore opt to pay only a small portion.

There is an ineffaceable notion that banks and their senior managers persistently champion their own self-interests ahead of other considerations. This was unmistakably the situation at the time the Australian government liberalized the financial markets in the 1980s; prior to the lifting of regulations the Australian major banks scrambled to bulk up in size and gain additional market share in order to forestall competition from prospective new international and local entrants. Several mergers and consolidations ensued among established financial institutions, and underwriting standards were reduced to accommodate more aggressive lending. The end result of their anti-competitive behaviour was disastrous because many of them embarked on a lending spree to unsound property development projects and highly leveraged entrepreneurs. Many banks suffered financial losses, and none of the previously state-owned banks continued to exist in their original form. Due to the problems that arose in this period the Federal government commissioned a new inquiry that eventually recommended the enactment of new regulations to safeguard the stability of the financial system and provide consumer protection.

The ratification of comprehensive regulations in Australia preceded other seemingly more stringent global regulations stemming from America as a consequence of corporate fraud perpetrated at Enron and other companies. All companies and banks with operations in America have since been required to comply with these regulations. The upshot is that most banks grumble about the need to conform to so many regulations in all the jurisdictions where they operate. They complain about the cost of manpower and time in ensuring legal compliance. A few institutions assert that their own standards, which arise out of institutionally ingrained ethical values, are higher than those legally stipulated. In such cases one would say that the righteous institutions should actually be pleased that others are required to observe similarly high standards and are not attempting to compete on a lower plane.

Here is where one finds merit in well-conceived regulations. Institutions must on their own initiative still develop and espouse ethical values but regulations bring recalcitrant entities into line and serve to look after the interests of consumers and others who are powerless vis-à-vis banks. As profit-oriented entities banks should seek their self-interest and defend themselves against competitors but they should possess moral values so that they do not injure customers and innocent bystanders in the process or engage in corrupt practices in order to attain their declared objectives. The chapter on the sub-prime crisis shall demonstrate how unbridled self-interest has harmed virtually everybody.

Some bankers will make a case that they fully comply with all the stringent regulations; others will contend that they go further and subscribe to corporate social responsibility practices; others will maintain that they esteem their reputation so much that they would not do anything to besmirch it. However, unless there are moral values that have taken root in the bank, one would deny that these other measures diminish the force of selfishness in the organization. To take specific examples, legal compliance does not inhibit bonus-hungry business strategists from trying to circumvent the laws in order to achieve their objectives; a bank might publicise its deeds of good corporate social responsibility, but, if some of its employees are dissatisfied with their jobs, they might not genuinely care about their customers and could even act in a detrimental way. In the case described earlier about a bank's handling of a stockbroker client that had gone bankrupt, the bank acted legally in disposing of the securities collateral in its possession without regard to the actual shareholders of those securities, but it subsequently realised that it had lost its reputation in the process by not considering the interests of the other affected parties. And this is a bank that sets great store by its reputation. In all these cases the banks were motivated by their self-interest. Ultimately what should matter is that banks have sound ethical values.

All banks these days proclaim in their annual reports that they practise good corporate governance and have established board committees to provide oversight in this matter. This may be beneficial for the corporation because it ensures that the interests of management are aligned with those of shareholders. However, this alone does not assure protection to bank customers, because the priority is still the bank's own interest. As pointed out above, during the financial crisis gripping the world in 2009 several banks still refuse to pass on interest rate reductions to customers because of their worries about their own profitability. Such behaviour can only be described as selfish and unfair.

C. Opacity or Transparency?

When one looks at how banks in Australia and Hong Kong behave towards their customers and stakeholders, one notes their declarations of service and adherence to good governance. At the same time one has seen how aggressive credit card promotion among some issuers has resulted in unjustifiable hardship among cardholders who should never have been granted credit cards. In reviewing the financial disclosure booklets that banks hand out to new customers, one might consider them opaque for most average personal clients.[5] Therefore the legal

[5] Even someone with a MBA in Finance might find it tedious to read such documents.

disclosure by banks may satisfy legal requirements but they would lack transparency for most individuals.

Banks might argue that they have developed authentic corporate social responsibility (CSR) and operate according to the right principles yet these may not be enough. The corporate responsibility goals enunciated by various banks include engagement with all stakeholders, concern for the environment, and responsible products, services and decisions. The steps taken include upgrading of skills and capabilities of employees, supporting the communities where they operate, enhancing financial literacy of customers, and offering micro finance to the disadvantaged. Nonetheless adopting a CSR programme or a code of ethics does not necessarily mean that a bank is behaving appropriately; as indicated in the earlier chapter on the Australian empirical research, a senior compliance officer at a major bank lamented that CSR at her bank was evidenced by spending large sums of money in sponsoring sports events followed by sponsorship of concerts. Both certainly served as good publicity, so they were intended to promote the bank's products and services.

Good corporate social responsibility should incorporate an effective code of ethics that is grounded on moral standards. Unfortunately many large institutions that proudly speak about their code of ethics are guilty of ethical violations. Several ethicists have analysed this situation and arrived at some explanations on the discrepancy between stated ethics policy and business practice. One paper cites two factors: ineffectual ethics programmes and defective corporate culture.[6]

To understand the apparent gap, one has to probe into the rationale within the specific institution behind the enactment of the code, the method of creation, the

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[6] Simon Webley and Andrea Werner, "Corporate Codes of Ethics: Necessary but Not Sufficient," *Business Ethics: A European Review* 17, no. 4 (2008): pp. 405-15.

content, and the implementation and administration thereof. The reasons might include a genuine desire to establish guidelines for the staff, or to safeguard against legal penalties, or to generate public awareness about its community deeds as well as its products and services. The principal motivation would shape the process of creating the code, which should include employees across a broad cross-section of the organization so there is participation and ownership throughout the firm. In his paper Schwartz lists six universal moral standards that should be included in the content of a code of ethics, namely trustworthiness, respect, responsibility, fairness, caring, and citizenship.[7] As one of the minimum moral requirements for a code of ethics he states that there should be prioritisation such that "specific provision must be included in the code to the effect that profits or self-interest must not receive greater priority than the fulfilment of the six moral standards."[8]

The background, process, and content shape the embedding and enforcement of the code of ethics in the institution. Deficiencies in the creation of the code frequently result in the difficulties of its application and administration, thus explaining the gap between policy and practice.

Therefore one must conclude that, while banks expend visible time and energy to publicise their community activities, they have not truly disclosed their full intentions. As a principal example, the senior banker in AU Interview 4 affirmed:

> We made a public commitment over a year ago that we would keep our call centres in Australia because that was a bit of an emotional issue. And in fact we just won an award for having the best call centre in Australia of any company let alone banks and that's for the third year in a row we've won that award. We made a commitment.

[7] Mark S. Schwartz, "A Code of Ethics for Corporate Code of Ethics," *Journal of Business Ethics*, no. 41 (2002): pp. 27-43.
[8] Ibid.

Two years after that senior executive made this pronouncement his bank announced the closure of their Australian call centres and their relocation to India. This is a bank that claims to pay special attention to the needs of their customers, which included a desire to speak with local bank representatives who could understand their situation, and this was the reason for the boast about their Australian-based call centres. Ultimately the bank must have accepted that its profitability could improve if these jobs were to be sent offshore.

Part C. Harsh Realities and Critique of Banking Ethics

CHAPTER 6. THE SUB-PRIME CRISIS: AN ETHICAL FAILURE?

A. Eviction from Homes

Although the empirical research was confined to banking practices and ethical conduct in Australia and Hong Kong, there were distress signals emanating from the United States as early as the end of 2006 and mounting in intensity and frequency as 2007 unfolded, and these would have unforeseen ripple effects on the entire global banking system. The financial events that emanated from America offer a profound and disturbing insight into the conflicts of interest afflicting banks and other lenders. The troubles arose when numerous American homeowners were unable to repay their mortgage loans as interest rates escalated, thus prompting lenders to foreclose on their properties. These loans generally had attractive low rates at the outset but would adjust after a grace period to reflect market rates and the higher risk category of the borrowers, who unfortunately lacked the financial capability to repay larger amounts of debt.

These were the so-called sub-prime loans for the purpose of acquiring homes that were granted to individuals who did not meet the normal credit standards of commercial banks. As the senior officer of a large American subsidiary of a major global financial institution explained in a letter addressed to this researcher:

> It is important to understand that the sub-prime market is comprised of ordinary citizens who, due to a troubled or non-existent credit history, find it difficult to obtain credit. These men and women and their families have pressing financial

> needs and require responsible financial services. We believe that the bank has a responsibility to provide them with fair lending and responsible credit.[1]

This clarification signified that the bank was guided by utilitarian thinking, which in this instance equated the optimisation of utility with greater home ownership among a broad spectrum of the population. The intended consequence of making homes affordable was viewed as a worthy objective.

The ostensible rationale for this financial product was to provide greater financial opportunity and flexibility to non-creditworthy individuals. Typically the borrower was not required to contribute any equity or down payment on the property and the lender provided 100% financing. There was little or no attempt to verify the income sources of the borrower and therefore no sensitivity analysis to ascertain the individuals' capacity to cope with interest rate acceleration. This omission concealed the precarious financial state of many borrowers. Though the problem had principally arisen in America, there were some lenders in Australia and Hong Kong that provided home mortgage financing to customers who would not normally qualify for bank loans. One financial institution that consented to an interview had attained a sizeable market share of Australian mortgage financing by offering such credit facilities. However, the senior officer of the American bank subsidiary quoted above stated that, despite a significant bank operation in Hong Kong and a large presence in Australia, they conducted sub-prime lending only in the United States. In fact, the evidence in both Australia and Hong Kong indicated a rigorous stance on the part of regulators against sub-prime lending. As disclosed by the CEO of the parent bank,[2] he objected strongly to his institution's purchase of the American sub-prime financial institution. He explained that the parent bank had excess liquidity that it could not

[1] Excerpt from respondent's comment to sub-prime queries in April 2007.
[2] Transcripts HK 8, AU 19.

adequately deploy, so the acquisition of the American institution represented an opportunity to substitute its liquidity for the latter's wholesale funding. As it turned out, the strict banking regulations in Hong Kong restricted this approach. Moreover, this CEO was concerned about potential damage to his bank's reputation, so how does one evaluate this ethical position? On one hand, it could reflect a serious worry about the business model of the acquired institution being uneconomically viable, that potential loan losses outweighed the increase of more clientele in the U.S. On the other hand, it might have been a genuine ethical anxiety that the bank might be extending housing loans to borrowers at risk, who could end up suffering as a result. The essential point to note is that here was a very senior executive of the acquiring bank who objected to the purchase of the sub-prime lender and later served on its board. Several months after the CEO's interview for this research and when the sub-prime problems first surfaced, this was the first bank to set aside a substantial loan loss provision and it terminated sub-prime lending by the American subsidiary. An objective observer would view this individual's conduct according to several ethical standards: firstly, there was a sense of duty towards customers in the sense of preserving the reputation of being a responsible, fair and honest banker; secondly, there might have been a purely rational concern that the risks of loss to the bank outweighed the benefits to be gained; thirdly, there might have been a utilitarian perspective that the scheme would do more harm than good to borrowers, contrary to the view expressed by the officer in the sub-prime lender. In the existential condition of this banker all three, or possibly more, ethical axioms might have been operative.

From the standpoint of justice the basic concept of sub-prime loans is problematic, whether the end-use is for home acquisition or credit card purchases, because it preys on the most vulnerable members of society, those who have impaired credit due to lack or loss of a job, marital or family problems, illness, or financial difficulty. These individuals, if they were financially illiterate, would very likely struggle with comprehending the complexity of a mortgage loan and the linked interest rate adjustments as well as their consequential impact on whatever disposable personal income they might have. To push such loans to susceptible individuals could probably mislead them to accept an unaffordable proposition. Such action would be morally reprehensible.

If one were to analyse this from the perspective of a Kantian categorical imperative one would definitely not apply this course of action to all persons in such circumstances because it would be impossible to argue that this is a universally moral act. Likewise it would be difficult for a consequentialist to argue in its favour because of the numerous homeowners whose properties have been foreclosed. On the other hand, most implicated financiers and mortgage lenders would possibly have viewed the situation in terms of subjective consequentialism[3] because they looked at intended and expected consequences of fairness and equality; they might declare that they were enabling individuals to acquire homes and consumer goods that they could not otherwise afford.

Yet there is another view that prudential credit standards developed by traditional banks have a sound underlying rationale borne out of lending experience, namely that borrowers require a determinate level of unencumbered income in order to repay loans and they must have the financial resilience to be able to surmount unforeseen problems and cope with increased repayments due to higher interest rates. The fact that countless foreclosures had already occurred (estimated at more than 2

[3] The term here refers to allegations of good intentions expecting positive consequences.

million in the U.S.A. as of November 2007)[4] is stark evidence that lending money to those who could not afford the repayments caused more hardship than benefits, and that such type of loans had no lasting, net utilitarian value.

Sub-prime loans were not only inherently unscrupulous because of the vulnerability of the prospective borrowers but also because this segment could easily give rise to grossly immoral practices on the part of lending institutions that resort to fraudulent means.[5] Since the borrowers were not required to provide proof of income, the lenders could easily manipulate the documents.

While there has been censure of the conduct of sub-prime lenders and approval of the sound credit standards observed by banks, the latter are not entirely blameless. Firstly, some of the large sub-prime lenders were directly owned by banking groups, which presumably were familiar with, and supportive, of the loan policies and operations of their subsidiaries. Secondly, though most banks laid great stress on reputation (as described in the interviews with bankers) and decried the behaviour of the non-banks, the latter would not have thrived without backing from the banks, which provided substantial lines of credit and were significant investors in mortgage paper.

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[4] Editor, "Keeping Americans in Their Homes," *The New York Times*, 19 November 2007, http://www.nytimes.com (accessed 21 November 2007).

[5] Bob Herbert, "A Swarm of Swindlers," *The New York Times*, 20 November 2007, http://www.nytimes.com/ (accessed 21 November 2007). The opinion article describes a family that was hounded by mortgage lenders to sign up to repeated refinancing of a mortgage on the mother's home despite lacking financial capacity. The lender falsely inflated the borrower's income despite the fact that the only source of income was social security payments.

B. Sub-Prime Mortgages Analysed

To comprehend the economic catastrophe that commenced in 2007 one should examine the nature and impact of sub-prime mortgages. In order to understand the problems affecting individuals it is helpful to take a look at the different types of mortgages that were available to individuals in America:

- Sub-prime: at a higher rate of interest for borrowers with poor credit history and low income
- Alt-A: at a higher rate of interest for people with poor credit history but better jobs
- Jumbo: mortgages over US$ 417,000 and not backed by government guarantee
- Prime: mortgages under US$ 417,000 and backed by government guarantee with stricter loan conditions (also called 'conforming')[6]

Sub-prime lending had spread rapidly in the United States, particularly in the frenetic housing markets of Florida, Southern California, Washington, DC, and New York City. One in five American mortgages came under this class. These had become widely accepted in a country that espoused home-ownership as the 'American dream.' They were very popular among individuals who did not qualify for housing loans at banks due to any of a variety of reasons: brief or no employment record, undocumented or inadequate earnings, lack of assets. Sub-prime mortgages involved a much higher risk of default by the borrower than other types of mortgage finance, because most of them were 'balloon' mortgages (technically known as hybrid-adjustable rate mortgages, or ARMs), which offered a low fixed-rate loan (as an introductory inducement) for two or three years, and then switched to a much higher adjustable rate afterwards. Moreover most of them did not require any down payment, so the loan to value ratio was at least 100% of the acquisition cost.

[6] Steve Schifferes, "Housing Meltdown Hits Us Economy," in *BBC News* (BBC, 2007), http://news.bbc.co.uk/go//pr/fr/-/2/hi/business/7078492.stm (accessed 12 November 2007).

Although such mortgage loans provided opportunities for home ownership to economically less fortunate individuals, they also gave rise to predatory lending practices. There were the so-called '*Ninja*' loans for people with no income, no job, no assets. There were the ubiquitous '2/28', mortgages that change from a fixed to a significantly higher adjustable rate after the first two years. Exorbitant prepayment penalties were standard, so the borrowers were precluded from trying to refinance at lower rates.[7]

In numerous instances the ill-fated mortgagors claim they were not aware interest rates would be reset or would rise to such an extent. They assert that most fees were not disclosed and separately itemized. Among them there is a prevailing sentiment of having been deceived. At the very least, there was lack of effort on the part of the lenders to inculcate financial literacy among the vulnerable, poorer members of society.

Christopher Dodd, Chairman of the U.S. Senate Committee on Banking, Housing and Urban Affairs, stated in his opening speech at a hearing on the mortgage market turmoil:

> These adjustments are so steep that many borrowers cannot afford to make the payments and are forced to refinance, at great cost, sell the house, or default on the loan. No loan should force a borrower into this kind of devil's dilemma. *These loans are made on the basis of the value of the property, not the ability of the borrower to repay. This is the fundamental definition of predatory lending.* (Italics added)
>
> Frankly, the fact that any reputable lender could make these kinds of loans so widely available to wage earners, to elderly families on fixed incomes, and to lower-income and unsophisticated borrowers strikes me as *unconscionable and deceptive*.[8] (Italics added)

7 ———, "Foreclosure Wave Sweeps America," (BBC News, 2007), http://news.bbc.co.uk/go/pr/fr/-/2/hi/business/7070935.stm (accessed 12 November 2007).
8 Michael Lewis, *Panic: The Story of Modern Financial Insanity* (W.W. Norton, 2009), p. 310.

The proximate cause of the sub-prime mortgage crisis was the upward tweaking of interest rates following the initial period that began in 2006 and gathered pace the following year. The soaring rates pushed monthly loan repayments beyond most borrowers' disposable personal incomes, causing them to miss instalments. As the problems escalated, the amounts of the loans quickly exceeded the value of the properties, so people stopped payments altogether or the lenders pre-empted them by foreclosing the homes pledged as collateral.

The accelerating repossession of properties brought an avalanche of forced sales of homes resulting in the first absolute decline of housing prices in the U.S. since the Great Depression in the 1930s. It was estimated that some cities saw property prices fall by as much as 30% towards the end of 2007.

C. Housing Meltdown

Borrowers, whose loans were at readjustment phases, found that interest rates had soared and new loans were unavailable, so defaults climbed even higher, and financial institutions, which had provided more than US$ 1 trillion of sub-prime debt, were sitting on these vacant properties, attempting to unload them in the market. These lenders also refused to extend any new financing, thereby compounding the credit crunch. The American National Association of Home Builders predicted in 2007 that the house building industry would contract by 50% in the next two years, eliminating 1 - 2 million jobs, and decimating many businesses.[9] In November 2007 The Economist reported that "The housing downturn has entered a second, more

[9] Schifferes, "Housing Meltdown Hits Us Economy."

dangerous phase: one in which the construction rout deepens, price declines accelerate and the wealth effect of falling prices begins to change consumers' behaviour."[10]

The source of the current turmoil lies with the bursting of the housing bubble, which had manifested itself in the doubling of house prices from 1997 till 2007. That price increase shaped America's economy in a manner that surpassed the construction boom. The Economist reported: "In particular, rising house prices provide consumers with the collateral they need for a huge increase in borrowing."[11] As with all bubbles, this asset bubble eventually had to burst. During the period between the middle of 2006 and early 2009, according to the Economist, "single-family home prices had fallen by nearly 27%. Existing home sales tumbled by nearly 40% from their peak in early 2005."[12] But the economic statistics of collapsing price levels did not begin to uncover the underlying human anguish.

In the questionnaires and interviews with bankers there was an explicit reference to a housing bubble in certain countries, particularly the United States, and the question was raised as to whether they thought that banks had contributed to this. The bankers denied that their respective institutions were responsible for this or encouraged excessive borrowing, but nonetheless they all agreed in 2006 that the American situation appeared worrisome.

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[10] "Getting Worried Downtown," *The Economist*, 17 November 2007, http://www.economist.com (accessed 19 November 2007).
[11] Ibid.
[12] Ibid.

D. Origins of Chaos

The roots of the turbulence in 2007 can be traced back to the Asian financial crisis of 1997 when several nations in the Far East, which had unwisely incurred sizeable current account deficits (encouraged with liberal loans from Wall Street banks), suddenly found themselves besieged by global currency speculators and hedge funds that were gambling that they could force these countries to devalue their currencies and thus reap substantial profits as a result. This wager paid off for many bettors, and wrought havoc on all the Asian economies, including some well-managed ones such as Hong Kong and Singapore. It thus became necessary for the International Monetary Fund (IMF) to intervene vigorously in order to forestall a global contagion.

> Much of the money lent by the IMF to bail out distressed economies had the effect of bailing out the Wall Street bankers who had lent to them with abandon. At the same time, extreme conditions were imposed on the IMF loans which in the short term enhanced the social and economic pain. It made many of these economies determined never again to let their destiny lie in the hands of others.[13]

These nations chose to tidy up their respective economies, reduce current account deficits, build up surpluses, and trim down inflation. They started to save frenziedly and invest domestically and internationally. The rapidly growing countries, China and Singapore, amassed huge liquidity in search of attractive investment opportunities.

Meanwhile the new American regime in 2000 suffered through the effervescence and subsequent puncture of the dot.com bubble that entailed start-up companies being founded in Silicon Valley by twenty-something entrepreneurs with innovative internet-based products and services, then being floated on stock

[13] Sean Farrell, "Anatomy of a Credit Crisis," *The Independent*, 6 November 2007, http://www.independent.co.uk (accessed 7 November 2007).

exchanges with neither track record nor profits, thereby creating instant young paper multimillionaires who would subsequently witness all their 'wealth' evaporate. This Internet bubble inevitably had to burst and lead to a stock market collapse. After this exuberant fiasco, the government endorsed a housing boom as the catalyst in rebuilding the economy.

The new American government policy initiatives advocated low interest rates in stimulating demand for credit and housing. The policies also leaned heavily in favour of free market forces in lieu of regulations in promoting innovation and prosperity; the prevailing attitude was that the marketplace would curb any competitive excesses.

The decade from 1997 was also characterised by low inflation on a global scale, which indicated that central banks in the major economies could sustain low interest rates. Although borrowers welcomed this situation, it frustrated the sizeable Asian investors whose ranks were soon joined by the oil producing countries, which were flush with cash from rising oil prices. This gigantic weight of money created an insatiable appetite for liquid investments that carried more attractive rates of interest than offered by U.S. government securities.

The investment bankers were more than happy to meet this enormous demand from investors with innovative financial instruments. Many types of high-yielding investment products were invented, and some of the most actively traded were secured by American sub-prime mortgage loans. The financial engineering transformed risky assets into high-yield investment grade instruments.

D. 1. Financial Wizardry

Sub-prime mortgage loans were extended to homebuyers with a deficient payment history, but the mortgages were cunningly repackaged into residential mortgage-backed securities or RMBSs. As of July 2007 more than 399 of these bonds had been downgraded by a rating agency with another 612 bonds about to be downgraded, worth US$ 12 billion. These were only a minor fraction of the mortgage market.

> The RMBSs are in turn divided up and placed in instruments called collateralised debt obligations or CDOs. These were sold to a wide range of investors, depending on their tolerance for risk. One set of securities, known as an equity tranche, pays the highest returns but is the first to suffer if the underlying bonds default; other securities offer a much lower yield but a triple-A credit rating, because a lot of defaults would be needed to trigger losses.[14]

While the initial impetus came from Asian investors and oil producing countries, numerous financial institutions soon flocked into the market. They were attracted by the investment ratings of these credit derivatives because of the scarcity of such high-grade debt. Although sub-prime mortgages were certainly not triple-A quality, they could be reengineered into securities via collateralised debt obligations through formulas that made default an extremely low mathematical probability. The rating agencies that provided the ratings also helped design these structured products. For example, a newspaper reported that Moody's earned more than 40% of its revenues from rating such products as CDOs in 2006.[15] Despite a voluntary code of conduct, agencies engaged in potential conflicts of interest because the firms they rated paid them. Passing judgment on CDOs was lucrative business for the rating

[14] "Another Pounding," *The Economist*, 14 July 2007, http://www.economist.com (accessed 16 July 2007).
[15] "Asking for Trouble," *The Economist*, 14 July 2007, http://www.economist.com (accessed 16 July 2007).

agencies, which were the midwives that helped give birth to these investment instruments.

> In the mid-1990s individual loans looked appealing to investors, but their ratings (often below investment grade) made them too risky for conservative types. So whole forests of asset-backed securities were put together into a single CDO. These were structured so that the first losses would be taken by whoever had bought the riskiest, highest-yielding piece of the package. That piece had a low rating. But the piece at the top, which would take the last losses, was rated AAA – a reflection of how unlikely it was that all the loans in the CDO would default at once.
>
> Rather than standing back and observing this from the sidelines, the rating agencies got involved in structuring these products. The agencies would suggest improvements based on their models.[16]

In his book, The Two Trillion Dollar Meltdown, Morris wrote that in five years from 2002 to 2006 the rating agency Moody's saw its income double and its share price triple. The firm's principal clients were the major banks and investment houses, which had always fought fiercely over the CDO bond ratings, so the agencies were frequently willing to compromise on these issues in order to continue receiving new business. The connivance of the agencies helped create highly attractive securities.[17]

D. 2. Upsurge in Securitisation

These new instruments proved to be very appealing to financial institutions not only in the U.S. but also in Europe due to further innovation by the investment banks in the form of new investment vehicles known as *conduits,* which were mostly not reflected in the banks' balance sheets and were funded in the asset-backed commercial paper *(ABCP)* market.

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[16] "The Game Is Up," *The Economist*, 18 August 2007, http://www.economist.com (accessed 21 August 2007).

[17] Charles R. Morris, *The Two Trillion Dollar Meltdown: Easy Money, High Rollers and the Great Credit Crash* 2009 ed. (Melbourne: Black, 2009), p. 77.

> The loans were typically cheap, usually roll over every few months, and are used to buy highly rated, but high-yielding assets, such as collateralised-debt obligations. The risk of short-term funding was always one of liquidity – and it dried up quickly once lenders became spooked. With triple-A assets, that had not been expected to become a problem.[18]

Conduits were very well accepted in North America and Europe because the top ratings of the underlying assets could permit the banks to minimize prescribed capital under the forthcoming Basle II Agreement and because these offered better returns than similarly rated U.S. government bonds. Thus by August 2007 the global ABCP market totalled approximately US$ 1.2 trillion, nearly doubling in three years.

> Yet the structured-finance geniuses did not stop at conduits. They ventured into structured investment vehicles *(SIVs),* which are similar, but more highly leveraged. SIVs have been one of the fastest-growing areas of structured finance, and they have been investing in riskier assets...23% of SIVs assets are in residential mortgage securities, half of which are American...some banks even manage *SIV-lites* (echoing the covenant-lite trend of the leveraged-loan market. These have fewer diversification restrictions and involve borrowings of up to 40 to 70 times equity collateral. Most *SIV-lites* made big, focused investments in American mortgage securities, including subprime and Alt-As, which are also troubled in spite of their better credit quality.[19]

However, if an unbiased critic or a prudent regulator had carefully scrutinized the fundamental structure of this securitisation and maintained that a triple-A rating was unwarranted, then the banks would have been obliged to set aside a larger portion of their capital to protect themselves against potential losses and, by doing so, they would have assumed more responsibility for their actions. Bank that commit a larger proportion of their own capital to transactions are more inclined to be responsible about the process and the consequences. One would hypothesize that

[18] "A Conduit to Nowhere," *The Economist,* 18 August 2007, http://www.economist.com (accessed 22 August 2007).
[19] Ibid.

they would probably have looked more carefully at the actual conditions of the borrowers and adopted more sensible lending standards.

Hedge funds, which employ a variety of techniques to enhance their returns, were also substantial investors in CDOs and SIVs. The heaviest losses were suffered by quantitative funds reliant on sophisticated mathematical tools for investment strategies, which had smugly calculated that the dramatic failures in the debt and equity markets in 2006– 2007 were statistically impossible.

Conduits and SIVs were extremely popular with hedge funds that borrowed enormous sums from banks such as Merrill Lynch, Citigroup, and other large banks in order to invest in sub-prime loans that were being packaged by the investment banks. The demand from investors grew so immensely that mortgage lenders were pressured to boost their production of sub-prime loans. The lenders, brokers, and their salesmen were only too happy to comply because these brought in substantial corporate profits and personal commissions. The bonuses paid to these bankers and other lenders were enormous. In their thrust to push sales further, these lenders dropped their credit standards and allegedly duped potential and existing homeowners into signing up for sub-prime mortgage loans. As investment banks gratified the hedge funds and other institutions, their earnings swelled.

D. 3. Unexpected Occurrences

Policymakers said they never saw it coming. Yet, when interest rates on sub-prime loans underwent readjustment, borrowers found themselves unable to meet repayments and started defaulting on their loans, which triggered a wave of foreclosures. But these occurred in multiple states across America creating a national housing disaster. The statistically impossible transpired, and mortgage bonds started to collapse in value sparking off dramatic falls in credit derivatives.

The additional risk in conduits and SIVs arose from their leveraged position in terms of loans or lines of credit provided by banks. As the valuation of RMBSs and CDOs plummeted, the banks demanded more collateral and, if none were delivered, they disposed of these assets, thus adding fuel to the frenzied sell-off of mortgage securities. Many banks were also caught holding mortgage loans in their portfolios that they had bought from other institutions and were planning to repackage and sell but could no longer do, so they had to write these off.

Investors were belatedly stunned by the gravity of the crisis when the rating agencies finally admitted the problem on 10 July 2007 and started downgrading the mortgage-backed securities and their derivatives. They were slow because they were under the impression the sub-prime troubles were limited to a few lenders, but the website www.ml-implode.com noted that 97 of them had imploded by July 2007 and 216 by January 2008.[20] A second reason was the complex structure of these securities that rendered them illiquid and difficult to value especially if they were kept off the balance sheets. As The Economist commented:

> Many of these securities are illiquid, so regular prices are not available...They may not recognise the problem until they are forced to by auditors or by rating agencies.
>
> Those required to ascribe a market value to these securities are faced with...a version of the prisoner's dilemma. Everybody would be better off if nobody traded, so that there would be no need to recognise lower prices. But if everybody is planning to sell, those who trade first will have an advantage.[21]

[20] "Another Pounding."
[21] Ibid.

CHAPTER 7. IMPACT OF SECURITISATION

A. Metamorphosis of Banking

Because a sub-prime loan was extended to someone with a poor credit record it was highly profitable to the lender, who demanded and received higher interest rates for the additional risk. Although a traditional bank had to carefully assess the creditworthiness of its borrowers in order to maintain sound asset quality because it provided loans from its deposit base, a sub-prime lender did not take customer deposits but funded itself from the money market. These lenders did not hold on to their loans but sold them off to investors.

Clever investment banks packaged these mortgage loans into bundles that were marketed to other financial institutions such as investment vehicles, hedge funds, banks, and insurance firms.

> This was meant to make the financial system more stable by dispersing risk and reducing the chance of a single bank being sunk by bad debts. But being able to offload debt encouraged some lenders to loosen their lending standards and make loans to riskier borrowers.[1]

The concept of securitisation, whereby loans arising from assets such as mortgages, credit cards, leases, and corporate loans were put together into parcels and sold as bonds into the market, transformed the nature of banking. This financial technique engendered three far-reaching consequences, namely disintermediation, diminution of accountability, and globalisation of risk.

[1] Farrell, "Anatomy of a Credit Crisis."

Disintermediation, which a senior Australian banker[2] cited as a feature of modern-day corporate finance, has been characterised by depersonalisation and the demise of traditional relationship banking. In situations where banks no longer lend to major customers out of their own balance sheets but rather sell off the loans as securities, they have less inducement to maintain regular contact with the customers, especially large corporate firms. Furthermore there is no motivation at all to personally communicate with retail banking clients, because mortgage loans and credit cards are processed, approved and serviced electronically; human interface is considered an additional cost. The present-day thrust of both banks and non-bank lenders is to generate more volume and fees without necessarily addressing customer needs. In such a situation there is a breakdown of community values and a slow disintegration of the social contract. This means heightened tension in trying to resolve the conflicts of interest between the institutions and their customers.

The second related consequence is a diminution of accountability, which has been generally considered as the obligation to provide an account of, or justification, for one's actions to one's stakeholders.[3] On the one hand, the financial institution providing the loans does not have to inform the borrowers how the funding is arranged and what transpires after the credit is released. On the other hand, the same institution might supply only scant data to the investors if a credit rating agency decides to stamp the securities investment-grade, which institutional investors look for. Until just recently these investors have not bothered to scrutinise the underlying loans that have been bundled into these securities. Given such ease of funding, credit

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[2] Transcript AU 9.

[3] Tracey Swift, "Trust, Reputation and Corporate Accountability to Stakeholders," *Business Ethics: A European Review* 10, no. 1 (2001): pp. 16-26.

standards were relaxed and reports emerged about instances of badgering and falsification of loan applications by loan mortgage salesmen.

The third consequence relates to the global nature of financial markets. Securitisation was very appealing to lenders because it facilitated funding and the transfer of credit risk. The attraction of securitisation for investors was the higher rates of return comparable to those for risk-free investments such as bond obligations of the U.S. Treasury, the Commonwealth of Australia, the industrialized countries, and triple-A corporations. In hindsight the elevation of RMBSs and CDOs to such a low risk category seems ludicrous and incomprehensible. But this greedy quest for higher returns during the build-up to the crisis meant that institutional investors from around the world acquired significant amounts of these sub-prime bonds. Global investors purchased these bonds without fully comprehending the underlying risks or their ethical ramifications. The global markets ensured the free transfer of these bonds, now known as toxic assets[4], to unwitting investors.

B. Implosion of the Sub-Prime Market

As home loan defaults escalated in the U.S., fears arose among financial institutions about the reliability of the mortgage bonds they were holding. The ensuing crisis of confidence wreaked havoc on the debt market because banks became reluctant to lend to each other due to apprehension about the counter-party's possible failure to repay. The extent of the calamity first evidenced itself in early August 2007 when a little-known German bank, IKB, announced it could lose billions of euros from its

[4] So called because they financially hazardous to the financial institutions that held them due to the probability of default of the underlying sub-prime loans.

investments in sub-prime American assets and required emergency funding so the German central bank and leading private banks stepped in to provide lines of credit. In November 2007 its shareholders decided to inject additional equity of EUR 2.3 billion. As a consequence, this bank had less funds to support its constituency, middle-size German companies, and its main shareholder, KfW, which is a development finance institution, certainly had fewer resources to finance projects in the developing world.

Even some small towns in Norway felt the ripple effects of the U.S. housing crisis.[5] These towns had invested its funds in complex securities sold by unscrupulous Norwegian brokers who placed the money in U.S. sub-prime mortgage instruments. There were fears that due to the losses the municipalities might not be able to pay for essential social services such as kindergartens, nursing homes and cultural establishments.

Foreclosures of American homes increased 30% from the previous quarter in 2007 and nearly doubled from a year ago; these were estimated to be one for every 196 households.[6] Repossessed properties eroded the value of the neighbourhood and the tax income of municipalities, thus impacting on their budget. By 2008 more than 2 million homeowners with sub-prime loans were affected. In January 2009 some economists were estimating that "8 to 10 million borrowers may lose their homes because they cannot afford to repay or refinance their loans."[7] Though this problem started with lower-income individuals being evicted from their homes, it spread to numerous communities in the United States, and even borrowers who paid on time

[5] Mark Landler, "U. S. Credit Crisis Adds to Gloom in Norway," *The New York Times*, 2 December 2007, www.nytimes.com (accessed 3 December 2007).
[6] Editor, "Spreading the Misery," *The New York Times*, 29 November 2007, www.nytimes.com (accessed 1 December 2007).
[7] Vikas Bajaj, "Mortgages and the Markets," *The New York Times*, 14 January 2009, www.nytimes.com (accessed 15 February 2009).

were suffering from higher interest rates. The human toll had become starkly evident. Access to commercial and industrial bank loans and the commercial paper market also became much tighter for corporations, thus posing a threat to job creation and business expansion.

C. Loss of Trust

The entire global financial market in late 2007 was filled with trepidation about the prospect of an American recession that could drag down most of the world's economies. Financial institutions, which had seen the value of their security holdings drastically diminished, started to hoard cash and stay out of the money markets. As liquidity evaporated, the New York Federal Reserve Bank announced that it would increase its funding for the markets and the European Central Bank committed to inject EUR 30 billion.[8] By the end of that first year 2007 the ECB had increased its allocation to EUR 348.7 billion.[9] As the next two years unfolded, the immensity of government intervention throughout the world would dramatically escalate.

The credit catastrophe was instigated by a breakdown of trust among financial institutions, which had ceased lending to each other for fear that they would not be paid back. One economist commented that "the collapse of trust has been caused by the bursting of the housing bubble.[10] From another point of view this may be the immediate cause but the root of the problems was the inability of various players to manage conflicting objectives without sacrificing the other parties' interests. But

[8] Sean O'Grady, "Ecb to Pump Eur 30 Billion into Money Markets," *The Independent*, 28 November 2007, www.independent.co.uk (accessed 30 November 2007).
[9] BBC News, "Ecb Lends $500 Bn to Lower Rates," (2007), news.bbc.co.uk/1/hi/business/7149329.stm (accessed 18 December 2007).
[10] Paul Krugman, "Innovating Our Way to Financial Crisis," *The New York Times*, 3 December 2007, www.nytimes.com (accessed 4 December 2007).

where does one lay the blame? Some disingenuous people lamely argued that "America's subprime borrowers themselves deserve a good part of the blame for the current mortgage mess. They were either greedy...or irresponsible."[11] On the contrary, the evidence indicates that many of the lenders and other key players have shown themselves to be untrustworthy.

The sub-prime lenders have typically demonstrated self-interest and greed in their pursuit of profit maximization. Sub-prime loans were initially priced at low interest rates in order to attract borrowers but would automatically readjust to higher interest rates after the introductory period. When the repayments became too demanding for borrowers, refinancing options were offered with new front-end fees and continuing high interest rates. Many of these loans seemed calculated to fail.

There is some credibility to the point of view that the counterpart of the sub-prime equation was 'consumer myopia' or the overconfidence of borrowers who previously could not receive any financing but were then enticed by the "lax lending standards to make calculated, if ill-advised, gambles."[12] If individuals unexpectedly received offers from banks willing to finance the entire cost of a house as well as the documentary and legal fees, they might have very readily accepted the financing.

> Most of these people did not suddenly run into financial trouble; they were betting that they would be able to buy the house and quickly sell it. Similarly, last year almost forty per cent of subprime borrowers were able to get "liar loans" – mortgages that borrowers can get by simply stating their income, which the lender does not verify. These loans were ideal for speculative gambles: you could buy far more house than your income justified, and if you could flip it quickly, you could reap outsized profits.[13]

[11] Gretchen Morgenson, "Blame the Borrowers? Not So Fast," *The New York Times*, 25 November 2007, www.nytimes.com (accessed 27 November 2007).
[12] Lewis, *Panic: The Story of Modern Financial Insanity*, p. 314.
[13] Ibid.

It is useful to draw attention to a distinguishing aspect of American mortgage laws, namely that a residential housing loan, secured by a mortgage on the property, is typically non-recourse financing. This means that, if the borrower is unable (or unwilling) to pay the loan, the lender can seize the property but the borrower is not personally liable. If the outstanding amount of the loan exceeds the value of the property, the lender is in an unfortunate position but may not pursue the borrower's other assets. The only exceptions would be in cases where the lender required another person as a guarantor or a co-signatory or insisted on additional security in the form of other assets. The commentaries infer that the sub-prime loans were all granted on a non-recourse basis.

Even accepting that some borrowers of sub-prime loans were speculating that house prices would rise quickly to enable them to sell and take profits or trade up to another property or refinance, responsible lenders should have cautioned them about prospective dangers if their financial condition did not warrant the magnitude of the loans they sought. Furthermore it must be stressed that the so-called 'liar loans' were not initiated by the borrowers but by the lenders, who had ample opportunity and legal right to verify the financial declaration of the borrowers yet chose not to do so.

These sub-prime mortgage loans were critical components of the collateralised debt obligations (CDOs), which were in great demand from investors seeking higher returns, so the investment banks innovated these new financial instruments. As described earlier, the credit agencies issued their investment-grade ratings and thus earned their fees. The securities were very popular with bond dealers in financial institutions, so investment banks collected good fees and earned more income as they engaged in trading these instruments.

However, even after a few investment banks discerned unacceptably high risk in sub-prime mortgages, they continued to sell the securities to investors and other institutions because they assumed that others ought to be able to do their own risk calculation. These institutions included those major banks that subsequently announced spectacular multi-billion dollar write-offs on their securities portfolios.[14] Several high-profile bank chief executives were later dismissed but with extravagant severance packages.

D. Mutual Mistrust and Credit Squeeze

When banks belatedly woke up to the reality of the greatly diminished value of their mortgage loans and conduits, they were forced to make provisions for potential losses and in most cases actually 'write down' these assets. Many financial institutions charged these against earnings, resulting in significant losses at several of the biggest ones: Merrill Lynch, Citigroup, Union Bank of Switzerland, and Bear Stearns. As the short-term advances of banks came due on maturity dates, they were compelled to borrow in the inter-bank market, which functions as a global clearinghouse funnelling liquidity from banks that have funds to those who need them. However, after mortgage loans started defaulting, banks were no longer willing to accept mortgage-backed securities or their derivatives as collateral and they stopped lending. Since these banks had their own conduits that invested in CDOs, they became risk-averse and no longer trusted the credit judgment of other banks. Thus banks began hoarding cash and, when they did lend in the inter-bank market, they did so only against verifiably high grade collateral and at higher interest rates.

[14] Jenny Anderson and Vikas Bajaj, "Wary of Risk, Bankers Sold Shaky Mortgage Debt," *The New York Times*, 6 December 2007, www.nytimes.com (accessed 8 December 2007).

The financial institutions naturally passed on the higher costs of funding to their borrowers, who were forced to accept prohibitive interest charges upon rate adjustment. This was particularly severe on sub-prime borrowers, who faced additional pre-termination fees if they wanted to refinance, so there was an escalation in mortgage loan defaults and housing foreclosures.

Companies were also confronted with serious financing problems. Those in the real estate industry discovered that they could no longer obtain or refinance their loans and were forced to cancel their development plans with some closing down their business entirely. Those in other industries suffered as well and found their expansion plans constricted. Employment was therefore curtailed in numerous areas.

The irony was that sufficient funds remained in the hands of individual banks but these had shut the spigot and blocked the flow of liquidity into the system. And this occurred on a global scale.

Normally interest rates on inter-bank lending closely track the rates set by the central bank, but these deviated radically in the early weeks of August 2007. The rates that banks charge each other for overnight borrowing soared to nearly 6%, considerably more than the Federal Reserve's intended rate of 5.25%. In the euro zone interest rates climbed to 4.7%, compared with the European Central Bank's target rate of 4%.[15]

People were startled by the sudden turn of events, but the world of banking can only thrive in an environment of trust; once that was lost, the streams ran dry.

> Lenders unsure of their ability to tell good borrowers from bad become less willing to lend to anyone at all. As markets become more suspicious, banks send a bad signal about their creditworthiness merely by seeking to borrow funds. Cash-

[15] "A Spike through the Heart," *The Economist*, 12 August 2007, www.economist.com (accessed 20 August 2007).

rich banks will hoard their money if they fear that the inter-bank market will cease to function, cutting them off from future supply.[16]

The response of the central banks in injecting huge funds into the money markets to provide additional liquidity succeeded in driving down money-market rates but did not solve the fundamental problem of mistrust, which continued to impede the smooth progress of the world's markets.

E. Panic in the Markets

While liquidity improved due to the infusion of cash from central banks, interest rates stayed high as banks tightened their credit standards. Realising that they had not properly priced risk in the past, they readjusted rates for individuals and companies after the event. When banks themselves had to pay more for funding, they passed on the cost to the borrowers. Even Australia and Hong Kong, which had little incidence of sub-prime lending, saw interest rates climb above what would be demanded in normal circumstances.

Fear gripped the global stock markets in 2007 because of apprehension about the probable recession in America contaminating the world's other economies. Investors were concerned that the travails in the housing sector would set off a collapse of the building industry, a rise in unemployment, and a likely drop in consumer spending as the realisation of diminished wealth sinks in. The Economist analysis reported that the drop in confidence due to the sinking markets and losses in the banks could exacerbate economic conditions and possibly lead to panic.[17] The

[16] Ibid.
[17] "Mortgage Flu," *The Economist*, 18 August 2007, www.economist.com (accessed 21 August 2007).

anxiety of investors was due to the key role of consumer spending, which constituted nearly 70% of American GDP and was therefore the principal determinant of the economy's outcome.[18]

Though seemingly distant, the major stock markets in Asia and Europe were plunging for most of 2007 while struggling to recoup some losses on occasional positive news, such as announcements from the U.S. Federal Reserve Bank of base rate reductions. The previous sanguinity of international investors emanated from confidence in three optimistic scenarios. The first was that the Federal Reserve would be able to save the markets and the economy, as its past track record had demonstrated. The second was that, even if the American economy stalled, Asia and other regions could pick up the slack in driving global growth. The third hope was that corporate profits would be resilient despite a global economic malaise.[19]

This optimism faded in January 2008 due to realisation that interest rate cuts take a long time to work their way through the economy and that production and exports from Asia are intimately linked to the U.S. economy. Share prices therefore went into freefall in all major markets during the third week of January, prompting the Federal Reserve to slash interest rates twice in the space of 8 days for an aggregate 1.25% reduction, the most aggressive effort it had undertaken in years to avert a recession.[20] The markets made a slight recovery but then shrugged off the first interest rate cut, because there was a sense of eager expectation for further lowering of the Fed funds rate.

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[18] "Getting Worried Downtown."

[19] "Why Markets in Asia and Europe Are Tumbling," *The Economist*, 21 January 2008, www.economist.com (accessed 25 January 2008).

[20] Edmund L. Andrews, "Fed Reduces Rate by Half-Point; 2nd Cut in 8 Days " *The New York Times*, 30 January 2008, www.nytimes.com (accessed 2 February 2008).

F. Initial American Policy Remedies

The American government response to the sub-prime crisis was characterised from the outset by adherence to ideological beliefs in free market capitalism and minimalist government interference. Despite warnings from a highly placed official within the Federal Reserve, there seemed to be little concern for the plight of individuals who would likely be adversely affected by the devious practices of sub-prime lenders. As early as 2000, Edward M. Gramlich, a Federal Reserve Governor, had warned: "Increased subprime lending has been associated with higher levels of delinquency, foreclosure and, in some cases, abusive lending practices".[21] Unfortunately Alan Grenspan, the Fed Chairman, refused to conduct investigations into such mortgage loan modus operandi. There was a distinct lack of ethical fervour on the part of regulators despite a law enacted by Congress in 1994 to regulate all mortgage lending:

> The language is crystal clear: the Fed "by regulation or order, shall prohibit acts or practices in connection with A) mortgage loans that the board finds to be unfair, deceptive, or designed to evade the provisions of this section; and B) refinancing of mortgage loans that the board finds to be associated with abusive lending practices, or that are otherwise not in the interest of the borrower.[22]

When the initial cases of sub-prime loan foreclosures occurred in late 2006, the Federal Reserve nonchalantly chose to take no action till a tidal wave of foreclosures broke through in the first half of 2007 and rating agencies started downgrading mortgage-backed securities, obligating auditors and banks to write down mortgage loans and all their derivatives. As described earlier, banks proceeded to write off

[21] Paul Krugman, "A Catastrophe Foretold," *The New York Times*, 26 October 2007, www.nytimes.com (accessed 30 October 2007).
[22] Editor, "A Crisis Long Foretold," *The New York Times*, 19 December 2007, www.nytimes.com (accessed 21 December 2007).

significant amounts of assets and refrained from lending to other banks as well as customers.

The subsequent measures undertaken by the Federal Reserve and the other major central banks, notably the European Central Bank, sought to alleviate the liquidity blockage by infusing cash into the monetary system. These were intended to assist the banks and other lenders, which were actually the original perpetrators of the sub-prime crisis, but did not mitigate against the problems of sub-prime borrowers, namely excessive interest charges and fees and foreclosure of their homes. The injection of additional liquidity simply allowed banks to continue funding themselves at central bank subsidised rates, but these did not reduce interest rates for besieged borrowers.

The second attempt by the American government under George W. Bush to address the problems came by way of asking the industry, that is, the investment and commercial bankers, to agree to a temporary freezing of interest rates. Despite several press releases, nothing significant was achieved, which one could ascribe to the expectation of voluntary restraint while the industry's constituents were only concerned with their corporate profits and personal bonuses.

The third attempt by the Americans came in the form of a fiscal stimulus, which at the start consisted mainly of tax cuts that would favour companies and all individuals, including rich ones, which was indicative of the policy preferences of the incumbent Republican president who had consistently shown his partiality towards big corporations and wealthy individuals. After internal strife within the legislature between the Democrats (who support the working classes and the poor) and the Republicans, agreement was reached to deliver cash refunds to individuals as well as tax cuts. Providing ready cash to the poor was deemed to be a quick approach to boost immediate spending that would stimulate the economy.

An important feature of the mortgage relief plan was intended to lower borrowing costs for a broad range of Americans, from middle-class families to those in danger of losing their homes, though critical aspects had not yet been settled. The objective was to permit the Federal Housing Administration to insure larger loans so that more people might qualify for lower-cost mortgages.[23]

The fourth approach was the assertive monetary federal funds rate slashing carried out by the Federal Reserve. Contrary to its earlier concern that such a move might ignite inflation, the Fed came to accept that the threat of recession was much more severe. The debate will continue among economists in the future as to whether there could have been another alternative to forestall inflationary pressures, but at the time this appeared to be the correct step to take if the benefits of lower rates could be rapidly conveyed to the struggling sub-prime homeowners.

G. Banking Collapse Averted

By October 2008 banks were haemorrhaging badly. The International Monetary Fund estimated worldwide losses on mortgage debt emanating from America at US$ 1.4 trillion, of which US$ 760 billion had been written off by banks and other

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[23] James R. Hagerty and Damian Paletta, "Elements of Mortgage-Relief Plan Still Need to Be Worked Out," in *The Wall Street Journal Online* (2008), http://www.realestatejournal.com/buysell/mortgages/20080129-hagerty.html (accessed 29 January 2008).

financial institutions at that that time. On a global basis, banks alone had suffered US$ 600 billion of loan losses.[24]

After continuous share market plunges and massive credit-linked write-offs, the major global banks were on the verge of collapse. Therefore on 14 October 2008 the American government decided to take radical measures and "announced plans to invest $250 billion of taxpayers' money into its banks, half of that into a group of nine of the industry's most celebrated names."[25] This was unprecedented action that followed strong Euro zone resolve on 12 October to establish sizeable stabilisation funds (Germany € 500 billion, France € 360 billion, the Netherlands € 200 billion). Britain pledged £ 37 billion to add capital to its banks.[26]

However the bank rescue did not restore credit flows because banks maintained that they expected funding to remain expensive, and they would also require a capital buffer against charges for potential bad assets. Banks had been saved but they still refrained from lending. The major criticism raised by Sheila Bair, head of the U.S. Federal Deposit Insurance Corporation, was the failure of the rescue package to address foreclosures.[27] This would have to await the arrival of the new Obama regime in 2009. One could form the view that major American and European banks, which had just faced possible extinction and only survived due to government life support, continued to be mainly concerned with their own profitability rather than the welfare of their clients.

In the meantime the American and British governments acquired equity stakes in several of their leading banks and other financial institutions. The injustice in the

[24] "When Fortune Frowned: A Special Report on the World Economy," www.economist.com (accessed 25 October 2008).
[25] "But Will It Work?," *The Economist*, 18 October 2008, www.economist.com (accessed 25 October 2008).
[26] Ibid.
[27] Ibid., p. 76.

view of many observers was that many of the financial institutions that had been saved with taxpayers' money continued to generously reward their fallen leaders and managers. Citibank, Merrill Lynch, and AIG were the notable ones that rewarded their top executives with huge bonuses despite the huge financial losses these firms had incurred. Merrill Lynch, which had once been a major Wall Street bank, sold itself to Bank of America because it was encountering severe funding difficulty. After the acquisition was consummated in December 2008 it was disclosed that that the firm would lose US$ 15.3 billion for the fourth quarter alone, and yet its chief executive, John Thain, was demanding a personal bonus of US$ 30 to 40 million, which was an outrageous claim under the circumstances, so he was compelled to resign.[28] It later emerged that Merrill's losses for the year amounted to US$ 27 billion and necessitated a government infusion of US$ 20 billion into Bank of America and a guarantee for US$ 90 billion of doubtful assets. Despite these heavy losses Merrill still paid out to 700 employees the sum of US$ 3.6 billion in bonuses for 2008.[29] In another controversial case, the giant insurance company AIG had suffered enormous losses of US$ 60 billion in the fourth quarter from the credit default swaps it had written and miscalculated.[30] It therefore required capital infusion and loans from the Fed and the U.S. Treasury to the tune of US$ 170 billion, which resulted in the transfer of 80% ownership to the American government, yet the company still authorised bonuses of US$ 165 million that would benefit the individuals in the unit that brought all the losses to the formerly highly profitable insurance company.

[28] Julie Creswell and Louise Story, "Thain Resigns Amid Losses at Bank of America," *The New York Times*, 23 January 2009, www.nytimes.com (accessed 15 February 2009).
[29] Michael de la Merced and Louise Story, "Nearly 700 at Merrill in Million-Dollar Club," *The New York Times*, 12 February 2009, www.nytimes.com (accessed 15 February 2009).
[30] Joe Nocera, "Propping up a House of Cards," *The New York Times*, 27 February 2009, www.nytimes.com (accessed 28 February 2009).

Executive bonus extravagance was rampant among these and other top financial institutions despite their recent disgrace.

The ethical problem does not lie in the concept of bonus payments but in rewards despite poor performance and financial losses, especially when the funds come from taxpayers who were coerced to save the enterprises. The chief executive of AIG lamely argued that the company had a contractual obligation to pay these bonuses in order to retain key employees, but President Obama found this unacceptable.[31] Insistence on obscene bonus payments in the wake of spectacular failure that has brought one's company to virtual bankruptcy can only be described as unabashed greed.

H. Accomplices in Bubble Architecture

Creating a financial system wherein average personal indebtedness has risen to 140% of assets is inherently inflationary and consumerist. It encourages a philosophy of hedonism and instant gratification. It suggests to the individual that he or she should purchase a home even if he may not be able to afford it now because the price will eventually rise and he can later flip it for a profit. In the meantime, if the nominal value of that property increases, he tends to spend increasingly larger amounts on luxury goods or agreeable items through his credit cards. This is a life predicated on the wealth effect of home ownership.

But it is a perilous motivation to live with the expectation that housing prices will forever continue on an upward spiral. And it is morally lax for banks to

[31] Helene Cooper, "Obama Orders Treasury Chief to Try to Block A.I.G. Bonuses," *The New York Times*, 17 March 2009, www.nytimes.com (accessed 19 March 2009).

encourage this form of behaviour, because such action by bankers illustrates a lack of concern for the good of individuals. In promoting these sub-prime loans the lenders have operated with a disdain for transparency, because they have not disclosed all the potential risks.

The banks would probably have espoused a utilitarian attitude at the outset with the objective of allowing more people to own homes. The innovation of complex mortgage securities facilitated the outflow of more sub-prime loans for home purchases but this resulted in a slackening of credit standards.[32] The banks were not alone because they were operating within the framework advocated by the American government of encouraging people to own their own homes. There were subsidies and tax concessions promoting home ownership, which eventually ballooned into a gigantic bubble that had to blow up.[33]

I. Ethical Deficiency or Selfishness

In this analysis of the sub-prime crisis it was apparent that the overriding objective of the lenders was to maximize profits through generating maximum fees and interest earnings from each borrower. It was obvious that that there was little attempt by most lenders to fully educate the prospective homebuyers about the complexities and hazards of sub-prime loans. Furthermore one would consider it imprudent to lend a sum of money equal to the purchase price of a property to an individual, who fails to qualify for a standard bank loan due to insufficient take-home pay, because the probability of his ever being able to repay the loan is extremely low. One might form

[32] "When Fortune Frowned: A Special Report on the World Economy," p. 11, www.economist.com (accessed 25 October 2008).
[33] Editor, "Building Castles of Sand," *The Economist*, 18 April 2009, www.economist.com (accessed 25 April 2009).

the view that granting a mortgage loan to such an individual without any warning of the inherent perils was an ethical failure.

It is quite possible to grant loans to persons who have limited sources of income and, with the right education and assistance, enable them to responsibly manage the prompt and orderly amortization of said loans. This has been proven in numerous instances of micro-finance,[34] where the borrowers' minimal income or paucity of assets should not prevent them from obtaining loans, but it requires dedication and genuine caring on the part of the lender, which must spend time with the borrowers to fully understand their situation and offer affordable loan facilities. This level of commitment is demanding and has rarely been observed in developed market economies, although some Australian banks claim to be providers of micro-finance. As role models of micro-finance, Grameen Bank in Bangladesh and its founder, Muhammad Yunus, were honoured with the Nobel Peace Prize in 2006 for their efforts in developing social and economic development through micro-credit.[35]

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[34] It is important to note that micro finance provides only relatively small amounts of credit to individuals to enable them to earn a livelihood and, in most cases, several members of the borrower's community act as co-signatories, so there is always a community involvement behind every microfinance loan.

[35] Grameen, "Prof. Muhammad Yunus & Grameen Bank Awarded the Nobel Peace Prize for 2006," (2006), http://www.grameen-info.org/index.php?option=com_content&task=view&id=2 (accessed 30 July 2009).

CHAPTER 8. CONCLUSIONS

Looking back from the perspective of July 2009 the world has witnessed nearly two years of rapidly deteriorating economic conditions that have ravaged all nations. This catastrophe had its origins in the sub-prime crisis that brought misery to millions of homeowners, overwhelmed banks and other lenders, and wreaked havoc on financial systems. Chapters 3 and 4 examined the comments by senior executives during the interviews, which were then analysed in comparison to the actions of their banks. The preliminary conclusions were developed from an examination of ethical practices in banking. The succeeding chapters probed into the origins and the ramifications of the sub-prime disaster. What went wrong? And how could things go so wrong? This chapter shall present the conclusions about the inherent ethical deficiencies in banks that were responsible for the gross problems that led to this modern great recession.

A. Forgetfulness of Responsibility

Sadly the current situation blares out the message that banks have forgotten the meaning of responsibility, which arises because financial institutions serve an essential and central role in all societies. The roots and inertia of the global financial crisis can be traced to the irresponsibility of banks.

The purpose of banking is to serve the community by enabling its constituents to save and protect hard-won earnings, fulfil dreams of home ownership, and achieve ambitions of generating wealth. Banks have also served as key partners for small and medium size businesses as well as major companies. Many people still recall neighbourhood banks that operated in their small towns or villages where the bank manager and employees personally knew many of the customers who came in to deposit funds and borrow money. As banks grew in size, they increased the number of branches as well as personnel. With the growth came efforts to consolidate and streamline the operations. What might have started as attempts at efficiency and modernization, such as use of computerized credit scoring for loan applications, automated teller machines, and the ubiquitous call centres have resulted in a diminution of customer interface. These advances have meant less personal contact between the bank representatives and the customers, so therefore current attempts to get to know the customers are scripted from a template that bank employees are obligated to observe as part of their due diligence and compliance. Credit card and loan applicants, who are encouraged to submit their requests over the phone or online, receive instant or quick approvals because prior to the financial crisis banks were keen to build up their loan portfolio. Customer focus has inevitably been lost. As this occurred on a large scale in America, banks ceased to pay attention to the personal situation of individuals, who reflect the needs of the community.

If one looks at modern banking through the eyes of Kant, one would probably argue that banks have long ago stopped treating their individual customers as persons or ends in themselves but rather as means to the end of maximizing profits, and this is an ethical failure. The American sub-prime crisis visibly illustrates how sub-prime mortgage lenders had become so detached and inured to the plight of average individuals that they did not even concern themselves with sensible questions such as whether the borrowers had jobs and how they expected to repay the loans. Because they were not interested in their customers as persons, these lenders ignored prudent practices requiring a maximum loan limit in relation to the property's appraised value, a mandatory minimum down payment, and proof of regular minimum income.

In forsaking good sense the lenders engaged in predatory techniques and deliberate omission of critical risk disclosure so they could generate these loans. Because housing mortgage loans are complicated and the impact of interest rate resetting is not readily comprehensible to the average borrower, there should have been extra care required of the lenders to ensure adequate financial literacy. However, the records of defaults and foreclosures point out that such care was not exercised in the situation of sub-prime housing mortgage lending.

As depicted in this case study of American sub-prime loans, many of the most afflicted borrowers were highly vulnerable due to their low or irregular earnings, insufficient savings to make a down payment, and possible financial illiteracy. Their desire was to obtain accommodation for themselves, but a more compassionate bank would have provided complimentary financial advice and steered them towards more affordable housing, either in terms of rental or government-assisted property. The form of sub-prime lending prevalent in America was irresponsible and harmful in its lack of transparency and its failure to safeguard the borrowers from potential loss and difficulties. The need of individuals for accommodation is a manifestation of the community's aspiration, which should be realised in a sustainable manner.

However, the reckless promotion of sub-prime loans triggered off pervasive defaults across America and instigated an avalanche of property foreclosures. The unrelenting forced sales of homes drove down housing prices and made it nearly impossible for other mortgagors to sell their assets into a falling market, thus precipitating further defaults and foreclosures. While homeowners were driven out of their abodes, numerous neighbourhoods stagnated due to the deterioration of the abandoned homes. The sequence of events evolved into a self-perpetuating cycle of ruin.

The burgeoning incidence of loan defaults and foreclosures eventually impacted on the mortgage-backed securities market that had been funding the huge growth of housing loans. When the vast extent of the sub-prime crisis was comprehended, panic spread among financial institutions and credit markets suffered a seizure. What originated as negligent lending and disregard of the customers' best interests ultimately degenerated into a financial crisis.

Banks perform a vital service for their communities and it is imperative that they assume and acknowledge full responsibility for the needs of their customers, who are the members of those communities. The conclusion is that financial institutions, particularly sub-prime housing lenders in America, have failed in this key role. The deficiency starts when customers no longer rank as the top priority for the institutions and this is exacerbated by manpower turnover, increasing automation, and unrestrained corporate pursuit of growth and profitability.

Based on the interviews and available market information until the end of the year 2008 it appears, generally speaking, that banks in Australia and Hong Kong have not been negligent in their treatment of customers, even though there have been many cases of sub-prime or 'low document' lending in the local housing market. These sub-prime lenders were non-bank financial institutions that were funding themselves through issuance of mortgage-backed securities. The world's largest non-bank lender, GE Money, had acquired Wizard Home Loans in 2004 and built it up to become the fifth largest mortgage lender in Australia but due to the turmoil of the global financial crisis GE Money decided to sell Wizard in late 2008 to Aussie Home Loans, a mortgage broker that is 33% owned by the Commonwealth Bank of

Australia. GE itself ceased third party mortgages, motor vehicle finance, and small business finance.[1]

The horrendous bushfires that had started burning through the Victorian rural areas on 7 February 2009 destroyed more than 1,800 houses and killed more than 181 persons by the 12th of February, so this was a real disaster zone leaving thousands of homeless people, many of whom had obtained mortgage loans. In a news report one person whose house survived the fires went to the Commonwealth Bank to speak to the manager about obtaining relief assistance on his mortgage loan because as a carpenter he was then unable to work and his wife could not go to her job since she had to look after their daughter due to the closure of schools as a result of the fires. He was told that his loan repayment could have a moratorium of three months after which he would have to pay the interest in full.[2] However, a neighbour of his was granted a three-month suspension of principal and interest by Bendigo Bank and told not to worry about the interest after that. These episodes, which demonstrate how banks treat individuals during a crisis, reveal the priorities different banks accord their customers.

During the latter months of 2008 till April 2009 the Reserve Bank of Australia had been cutting interest rates with the expectation that banks would pass these reductions onward to their housing mortgage customers, but it was frustrated that most of the major banks refused to do so because they claimed they were encountering high interest rates in their offshore borrowing (despite government guarantees); in other words, they wanted to ensure that they could maximize their

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[1] Sid Maher, "Ge Money to Cut 335 Staff as Financial Crisis Hits Home," *The Australian*, 24 October 2008, http://www.theaustralian.news.com.au/story/0,,24545562-643,00.html?from=public_rss (accessed 01 February 2009).

[2] Michael Vincent, "Fire Victims' Mortgage Reality Hits Home," (ABC News, 2009), http://www.abc.net.au/news/stories/2009/02/12/2489534.htm (accessed 13 February 2009).

profits. To highlight the irresponsibility of banks, when the Reserve Bank cut interest rates by 0.25% in the middle of April 2009, the National Australia Bank (NAB), chose to *reduce the deposit interest rates it paid to children by 0.25%.* The Australia & New Zealand Banking Corporation (ANZ) cut *its children's deposit rates by 0.50%.*[3] This is the height of irresponsibility by NAB and ANZ: firstly, to refuse to pass on the interest rate reduction from the Reserve Bank to borrowing customers, and secondly, to reduce the interest paid on the savings deposits of children, who are highly vulnerable and are encouraged to develop good savings habits. This is a blatant example of how major banks exploit their customers who are perceived to be docile. The Reserve Bank had implemented its interest rate adjustments to alleviate the burden on mortgagees who were struggling to cope with the harsh economic conditions but the banks preferred to keep the benefits for themselves, which was clearly selfish. But reducing interest rates paid to children was very callously wrong and unquestionably unethical.

B. Injustice

The events leading to the global credit crisis clearly illustrated the lack of fairness on the part of bankers, especially as exemplified in the housing loans and collateralised mortgage obligations in America, but even as the travails spread throughout the world many of the banks displayed a lack of sensitivity to the harm they had caused. The sub-prime mortgage disaster unmistakably displayed the greed of lending institutions that were zealously aiming for expansion of their housing loan portfolios and of bank

[3] Jacob Saulwick, "Banks Cut Rates on Children's Accounts," (brisbanetimes.com.au, 2009), http://business.brisbanetimes.com.au/business/banks-cut-rates-on-childrens-accounts-20090415-a7ix.html (accessed 31 July 2009).

employees keen to receive their fat bonuses. Since the institutions had ceased to relate to the customers, they ignored the financial condition of the borrowers and their ability to repay the loans. In view of the fact that investment banks were bundling these mortgages into asset-backed securities and selling them to institutional investors hungry for high returns on investment-grade financial instruments, the lenders did not worry about repayments on the loans. The investment bankers were fanatical in designing and underwriting these mortgage-backed securities because of the enormous bonuses they would receive.

During the worst moments of the crisis in May 2009 only six banks in the world managed to retain their double A rating (AA) among which were the big four Australian banks, which were the very ones keen to preserve their profitability and therefore reluctant to pass onward any interest rate reduction from the central bank. The government's guarantee on the banks' debt to enable them to obtain lower cost overseas funding also failed to induce the banks to reduce their rates. One could view this as a sign of ethical lapse into selfish greed.

B. 1. Rational Actor Theories

During the long boom period that ended in 2007 most financial institutions enjoyed hefty profits from lucrative lending, trading, and innovative advisory activities. The case study on the sub-prime crisis and its devastating aftermath pointed to widespread abuses resulting in people losing their homes, investors seeing their assets evaporate, and institutions unable to fund themselves. Yet most banks boasted that they were good models of corporate governance, usually meaning that they maintained proper compliance standards, which had arisen out of common practices, codes of conduct, regulation, and a structure governing societal relationships. One would conclude that the banks were able to pursue their profit objectives while ostensibly satisfying regulatory requirements put in place to protect other members of society. How can one identify their motivation and ethical considerations?

One approach in examining this is the 'rational actor model'. The rational actor is defined as a denizen of an imaginary world conceived by contractarian theories. The rational actor model may also employ a modified utilitarian model of the good in a well-intentioned attempt to impute moral-theoretical justification to specific action and concepts. This model is exemplified by the following key features: (1) human rationality, (2) rational behaviour demonstrated by preference- or value-maximization, (3) business profit-maximization, (4) utility as the measure of moral goodness, therefore, (5) ethical business practice is interpreted as striving after maximum profits within a structure of progressive though not well-circumscribed rules, rights, and obligations.[4]

This rational actor model was applied to the interviews with banks and other financial institutions in Australia and Hong Kong. Their statements and annual reports certainly highlighted the importance of profits among their priorities. At the same time many of them proclaimed that they practise corporate social responsibility, which they regard as concern for their stakeholders. A number of the bankers explicitly claimed that they supported the long-term viability of their clients because only by doing so could they themselves be assured of long term profitability. They made a similar assertion with respect to a desire for the long-term sustainability of the environment, though some of them did not consider it appropriate or timely to adopt

[4] Janet McCracken and Bill Shaw, "Virtue Ethics and Contractarianism: Towards a Reconciliation," *Business Ethics Quarterly* 5, no. 2 (1995): p. 297-312.

environment protection principles ahead of a commitment by the Australian government to such an ideology.[5]

The philosophical interpretation of rational action as an explanation for risk comes in three levels of abstraction. In its most extensive form it assumes that human beings are capable of acting purposefully by relating choices with results. People act strategically, focusing on objectives, and make decisions to achieve their goals.[6]

The second, more advanced form of rational action, which is known as the *Rational Actor Paradigm* (RAP), is a theory that assumes human actions are based on individual decisions. The major assumptions include the following: all actions can be distilled into individual choices; individual and institutional decision-makers can differentiate between goals and the steps needed to attain them; individuals are driven towards their selected targets; rational actors seek to maximise or optimise their utilities; people are aware of possible consequences of their actions; people's preferences for results arise out of personal values and expectations; human actions can be predicted if individual preferences are revealed.[7]

The third level of application of the RAP attempts to explain collective or institutional behaviour. Since RAP theory has postulated that individuals maximise their satisfaction or utility by selecting among several options the one choice that assures maximum return, the corporate or collective interpretation claims that rational action leads to overall satisfaction and socio-economic stability on the further assumption of free market competition. The principal gist is the hypothesis that factors controlling individual action are similarly applicable to the analysis of

[5] The Australian Conservative Prime Minister John Howard, who was defeated in the Federal election on 24 November 2007, had refused to ratify the Kyoto Protocol on the environment, but the first act of his Labor Party successor Kevin Rudd was to confirm that he would reverse this position.
[6] O Renn et al., "The Rational Actor Paradigm in Risk Theories: Analysis and Critique," (2000), www.kent.ac.uk/scarr/events/finalpapers/renn.pdf, pp. 1-21 (accessed 10 March 2008).
[7] Ibid.

corporate behaviour. In line with this overall postulate the critical assumptions are that organizations act like individuals and the 'invisible hand' operates as an equilibrium mechanism. The interpretation of RAP in the corporate context assumes that all human behaviour amounts to optimisation.[8]

In the discussions with the senior bankers in Australia and Hong Kong, several elements of the Rational Actor Paradigm were clearly evident. Firstly, each institution was focused on increasing shareholder returns or, in other words, augmenting profitability either through sales expansion or cost reduction. Secondly, all managers and employees were similarly committed to this goal because salary and bonus compensation schemes were unmistakably linked to their individual contribution to sales growth and profit maximization. Both targets were manifest in corporate policies and practices. Thirdly, all the institutions were conscious of their need to comply with governmental regulations despite the realisation that compliance could hinder attempts at optimisation.

There were ubiquitous references to customer service and corporate social responsibility. But each institution noticeably publicized its financial goals and later proudly proclaimed the actual results as compared to the targets. This was entirely comprehensible because the financial institutions were publicly listed on the share markets and the share price movements reflected analysts' and investors' views on how successfully the firms had achieved their stated targets. There was strong motivation on the part of top executives as well as other managers to attain their goals. These objectives were typically expressed as profit growth and market share expansion, measured quarterly over a one-year period, so the time horizon for the corporation is undeniably short-term rather than long-term.

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[8] Ibid.

In a similar manner, the board directors and senior executives reviewed the performance of the bank managers and staff members annually and rewarded them with bonuses for the immediate past without significant provision for future consequences of the loans, transactions or services attributed to the individuals. Although banks with a sense of responsibility (the majority of participants in the study) incorporated non-tangible measures in performance appraisal, such as evidence of ethical behaviour and appropriate values, it would appear that most financial services firms generously rewarded their managers irrespective of the corporate performance. An analysis of executive compensation for the year 2007 revealed that despite massive losses from the sub-prime crisis suffered by major financial institutions resulting in the dismissal of several chief executives and other senior officers, a good number still received munificent bonuses. The sacked CEOs walked away with massive fortunes.[9] In these instances the executives failed their shareholders, triggered sizeable losses for investors, and caused countless ordinary people to lose their homes, and yet the system still rewarded them. A New York Times editorial complained about "the fact that chiefs at 10 financial-services firms made $320 million last year, even as their banks reported mortgage-related losses of $55 billion."[10]

The RAP is a useful analytical tool for application to a study of ethics in banking because the theory is premised on individuals and groups seeking to maximise goals. Many of the American financial institutions in the case study corroborated the hypothesis of optimisation. Several comments from bank executives in the empirical research likewise allude to the importance of profit optimisation,

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[9] Claudia H. Deutsch, "A Brighter Spotlight, yet the Pay Rises," *The New York Times*, 6 April 2008, www.nytimes.com (accessed 8 April 2008).
[10] Editor, "Corporate Croesus," *The New York Times*, 8 April 2008, www.nytimes.com (accessed 10 April 2008).

while reported acts on non-transmittal of interest rate reductions to customers confirm the primacy of profit continuation for banks.

B. 2. Deficiencies of the Rational Actor Paradigm

The principal deficiency of the RAP in analysing both individual and collective behaviour is the assumption that the actors have sufficient knowledge about the possible consequences of their chosen path of action.[11] When analysing the history of the sub-prime crisis and banking in general, one realises this is obviously not the case because banks have periodically encountered problems in various guises. To take the example of the sudden collapse and startling rescue of a leading Wall Street investment bank, Bear Stearns, the Federal Reserve Bank of New York engineered during the course of a weekend its acquisition by a much larger bank, JP Morgan Chase, because other financial institutions had abruptly ceased to provide funds to Bear. The takeover price was initially for US$ 2 a share, but was later raised to US$ 10 a share. Several critics subsequently commented that the Federal Reserve should have called in Bear's chief executive earlier and proposed lending directly to the bank or encouraged him to raise additional capital prior to the rapid turn of events necessitating a bailout. But, when the ill-fated CEO was subsequently questioned on what he would have done differently, he said that he did not know at the time or even later.[12]

Uncertainty about the future presents all banks with risks, which create opportunities for the institutions but are also the reason that a regulator such as the

[11] Renn et al., "The Rational Actor Paradigm in Risk Theories: Analysis and Critique."
[12] Andrew Ross Sorkin, "Jp Morgan Pays $2 a Share for Bear Stearns," *The New York Times*, 17 March 2008, www.nytimes.com (accessed 17 March 2008).

Hong Kong Monetary Authority is predominantly concerned with the quality of risk management at the banks operating in Hong Kong. There are several definitions of risk but the one employed by Rosa is especially relevant: "Risk is a situation or event in which something of human value (including humans themselves) has been put at stake and where the outcome is uncertain."[13] The critical elements of this definition are the involvement of human beings and the uncertainty of consequences. The banking world tends to view risk in certain narrow categories, which usually refer to risks confronting the banks such as: financial loss, failure of borrowers to repay, failure of institutional counterparties to deliver, liquidity, reputation, insider and external fraud, bankruptcy, but there has been scant attention to the plight of the marginal individual except as a purchaser of banking products. The risk management of banks is chiefly directed at ensuring profits and positive reception in the stock markets. On the other hand, the regulators are mainly concerned with systemic risk, namely that the failure of a large bank could trigger repercussions throughout the entire financial system or that loan losses at banks could cause widespread distrust and panic, which would quickly evolve into a rampant liquidity crisis. Both events occurred during the financial crash of 2007 – 2009, starting in America but spreading globally very quickly.

According to Alan Greenspan, former Chairman of the US Federal Reserve, "Risk management systems – and the models at their core – were supposed to guard against outsized losses. How did we go wrong?"[14] He argued that the sophisticated mathematical models could not fully encapsulate all the dynamic variables of economic reality. The computers were programmed to lower risk through

[13] Eugene A. Rosa, "Metatheoretical Foundations for Post-Normal Risk," *Journal of Risk Research* 1, no. 1 (1998).
[14] Alan Greenspan, "We Will Never Have a Perfect Model of Risk," *Financial Times* 2008, www.ft.com (accessed 18 March 2008).

diversification, whereby varying types of assets would offset each other's movements, but instead, as Greenspan wrote, "when they fell in unison on and following August 9 [2007], huge losses across all risk-classes ensued."[15] This clearly demonstrated that even the highly motivated, well-paid econometricians and their innovative financial models could not predict the probability of occurrence of a financial catastrophe.

The second major deficiency of the Rational Actor Paradigm is that the actors seek to maximize utilities such as money or material goods but not a good such as mutual trust, which is the very foundation of banking. This has been clearly illustrated in the breakdown of the inter-bank money markets commencing in August 2007 and lingering months thereafter. Jaeger commented that RAP was unsatisfactory in "creating mutual trust among actors, building individual and social identity, achieving ontological security, or constructing solidarity among people."[16]

When a sales person at a bank or mortgage lender offers a financial product such as a mortgage loan, that agent has self-interest in closing the sale in order to earn a commission and a potential bonus. Although the banks interviewed stated that they offered training programmes for all their staff so that they would be attentive to the needs of their customers, there is no denial of the fact that employees are financially rewarded for sales and profit contributions. However, several bankers in the study asserted that their institutions consciously mandate prudential guidelines such as adherence to a maximum loan to valuation ratio and verification of a borrower's ability to repay the loan. It is only through such principles and discipline that a bank can implant the motivation in its employees to genuinely look after their customers'

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[15] Ibid.

[16] Carlo C. Jaeger et al., *Risk, Uncertainty, and Rational Action*, ed. Ragnar Löfstedt, Risk, Society, and Policy (London: Earthscan Publications Ltd., 2001), p. 245.

interests. This is probably the reason that Australia and Hong Kong did not experience the sub-prime housing problems afflicting borrowers.

The third deficiency of the Rational Actor Paradigm is that certain individuals, who are key components of the banking system because some of them provide the savings while others borrow the funds of the savers, have been discovered to be financially illiterate. Niall Ferguson, an economic historian at Harvard University, revealed in his research that a sizeable percentage of the general public in the English-speaking world is either ignorant or badly informed about finance.[17] The Economist wrote about money:

> Everybody wants it. Nobody understands it. Money is the great taboo. People just won't talk about it. And that is what leads to subprime. Take the greed and the financial misrepresentation out of it, and the root of this crisis is massive levels of financial illiteracy.[18]

Since individual customers are critical actors in the banking scenario, their lack of financial literacy, which has been exposed, would have connoted a lack of understanding of the basics of savings accounts and investment plans, not to mention the intricacies of home mortgage loans with their myriad front-end fees, compound interest rates, and penalty fees. Ferguson noted that financial illiteracy reveals itself in all age ranges, income levels and countries. Well-educated persons are similarly afflicted. Such being the case, one would conclude that it might not be reasonable to apply the RAP analysis to most individual bank customers, who could not fully comprehend the ramifications of decisions and loan contracts that bankers were compelling them to make. Most individual clients would have acted irrationally.

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[17] "Getting It Right on the Money," *The Economist*, 5 April 2008, www.economist.com (accessed 12 April 2008).
[18] Ibid.

If financial illiteracy is a prevalent syndrome, consider the plight of poor people who frequently do not even have a bank account because they might not have any funds to set aside and do not appreciate the value of savings. Their underprivileged economic condition rendered them unwitting targets for sub-prime mortgage loans in America and other countries where financial institutions offer similar financing. Without a doubt such disadvantaged people were not even remotely aware of the consequences of taking out sub-prime loans without a meaningful down payment and adequate repayment capability.

B. 3. Misguided Risk Management

Risks are present in everyday life and all activities. In the financial sphere depositors keep their money in banks because they trust the institutions to safeguard their funds from the risk of loss. If customers wish to earn additional returns on their money, competent financial advisors would inquire about their level of risk tolerance so they can be offered the appropriate savings or investment product. If the clients are not financially literate or the products are not explained sufficiently, they could well be assuming excessive risk.

Just as an individual must clearly identify his risk profile and select his appropriate risk preference, much more so should a bank. It is important that banks produce sufficient income and services for their various stakeholders: dividends for the shareholders who provide the capital, fair salaries for the employees who serve the customers, interest earnings for the depositors who supply funds for loans, revenues for the institutional investors who provide funding in the open market, straightforward financing for individuals who wish to purchase homes and use their credit cards for convenience, manageable corporate finance for companies which require funds for operations or expansion. In order to achieve these goals banks have to assume numerous risks or else be unable to fulfil their roles. Risk management can be broadly classified under two principal categories: asset management is concerned with *credit risk*, that is, the quality of the loans and investments; liability management focuses on *liquidity* and *market risks*. One disturbing conclusion is that in the circumstances of the sub-prime crisis countless financial institutions were overly enthusiastic about accepting amplified risks in the expectation of greater rewards.

B. 4. Abandonment of Prudence

An assessment of the coverage of the crisis leads one to believe that the emphasis of the financial institutions was on liability management at the expense of prudent risk asset management, which was shown in the active reliance on funding through residential mortgage backed securities. As described in Chapter 6 there was scant regard for asset or credit quality because the lenders were mainly interested in writing home loans. From an objective perspective, this runs counter to principles taught in rigorous credit training programmes at prudential banks, which would always highlight the importance of ascertaining the source and timing of repayment. However, it did not matter to the sub-prime lenders whether or not the borrowers could repay their obligations, because they presumed they could sell off the mortgage loans without recourse through various modes of asset securitisation. It was precisely this neglect of the individual that eventually ignited the bonfires of the sub-prime crisis.[19]

Much subsequent economic analysis of the sub-prime crisis and the global financial calamity that it unleashed has focused on the mathematical models underpinning the risk management of banks. An implicit assumption in the financial modelling of banks and rating agencies was that house prices would gradually increase over time.[20] Such a postulation underlined the risk asset management at nearly all sub-prime lenders, namely that even if the borrowers could not repay the loans, they could easily put up the properties for sale or the banks could foreclose and gain from a forced sale. This mode of thinking was inflationary and pervasive. Consumers were persuaded that they needed to urgently purchase their own homes because prices would keep rising, while the lenders abolished down payment requirements, relaxed their underwriting criteria, and offered attractive interest rates for the initial two year period. Prudential standards were abandoned.

A post mortem by several Federal Reserve economists revealed that loans with low documentation on income or assets and those with high leverage displayed greater defaults than others.[21] The same study described four methods for classifying sub-prime loans: (a) borrowers needing repeated reminders and are therefore charged higher service fees; (b) lenders concentrating on loans to individuals with defective credit records; (c) loans incorporating steeper fees and rates than normal; (d) the loan

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[19] Steve Lohr, "In Modelling Risk, the Human Factor Was Left Out," *The New York Times*, 5 November 2008, www.nyt.com (accessed 7 November 2008).

[20] Mardi Dungey, Jerry Dwyer, and Tom Flavin, "Vintage and Credit Rating: What Matters in the Abx Data During the Credit Crunch?," in *Federal Reserve "Day Ahead" Conference on Financial Markets* (San Francisco: Federal Reserve Bank of San Francisco 2009), http://www.frbsf.org/economics/conferences/0901/Dungey-Dwyer-Flavin.pdf (accessed 2 February 2009).

[21] Kristopher Gerardi et al., "Making Sense of the Subprime Crisis," in *Brookings Papers on Economic Activity* (USA: Brookings Panel on Economic Activity, 2008), www.brookings.edu/economics/bpea/bpea.aspx, pp. 8-9 (accessed 7 November 2008).

might be a component of an asset-backed security labelled as sub-prime.[22] A significant factor emerged that prior to 2004 sub-prime loans were usually supplemented with considerable equity in the properties. Loans with low documentation and excessive leverage grew from nil in 2001 to nearly 20 percent of new transactions in 2006. The theoretical view was that a borrower with positive equity in his home would choose to refinance or sell the property rather than default or allow foreclosure. However, in a situation where housing prices were dropping rapidly the highly geared borrowers ended up in negative equity and lost any semblance of control over their fate.

B. 5. Initial Market Reception

Given the inherent risks of this type of loans, the key question is why investors did not foresee the sub-prime mortgage disaster. The explanation lies in the dexterous liability management by the issuers and the investment banks, which were able to present the residential mortgage-backed securities in an appealing light. These securities readily satisfied the perceived demands of institutional investors in the market on asset quality, decent income, and predictable income stream.

> Five basic themes emerge. The first is that the subprime market was viewed as a great success story in 2005. Second, subprime mortgages were viewed, in some sense correctly, as lower risk because of their more stable prepayment behavior. Third, analysts were hampered by the absence of episodes of falling prices in their data. Fourth, many analysts anticipated the crisis in a qualitative way, laying out, in various ways, a roadmap of what could happen, but never fleshed out the

[22] Ibid., p. 6.

quantitative implications. Finally, analysts were remarkably optimistic about HPA [house price appreciation].[23]

As noted in the earlier discussion of the sub-prime crisis, the rating agencies, which were supposed to be independent bodies passing judgment on the investment qualities of debt issuers and debt offerings, were coaxed by the banks to propose the appropriate combination of assets to bundle into RMBSs or CDOs so these could be classified as triple-AAA debt issues. Presented with such highly rated securities, the investors chose to forego their own due diligence and further analysis. The automated credit scoring system used by banks also gave the impression that the credit quality of sub-prime borrowers had improved.[24] There was likewise the perception that the lenders had improved because these were larger institutions.

Curiously the prepayment risk was viewed as more stable than on traditional prime loans, but the reason for this was the high penalty levied on prepaying sub-prime loans that was presumed to discourage prepayments. But this penalty would not prevent defaults on the loans.

When the event for which the analysts had assigned low probability, the slowdown of house price appreciation, finally occurred, it sparked off defaults and foreclosures among millions of homes.

B. 6. Contagion

After the sub-prime crisis blew up, the economist Mardi Dungey raised the question: "why did a crisis that originated in a relatively small segment of the US financial

[23] Ibid., p. 26.
[24] Ibid., p. 27.

system result in the most severe crisis since 1929?"[25] She estimated the global equities and government debt markets to be a hundred times bigger than the US sub-prime market, yet the American mortgage calamity rapidly infected the entire global economic structure. Economists view contagion as the cross-country transmission of financial shocks beyond fundamental linkages. The conference paper of Dungey, Dwyer and Flavin finds the causes in the use by banks of special purpose vehicles that were off-balance sheet, highly leveraged, and utilised to fund sub-prime mortgage loans and other loans. Because these vehicles were maintained separately from the balance sheets of banks they were outside the purview of most banking supervisors, except in Spain, which had forbidden the use of such techniques. Regulators did not realise the extent of huge leveraged global investments in American sub-prime assets because these holdings were mainly carried outside the balance sheets of banks. Once the underlying mortgages started to default, the financial contagion spread rapidly across national borders.

C. Challenges to Integrity

In reviewing the interviews conducted with senior bankers in Australia and Hong Kong it was gratifying to come across individuals who affirmed ethical values personally and on behalf of their institutions. However it was perturbing to learn from the senior compliance officer for Australia of a considerable institution that prevailing practices in her bank continued to be driven by selfish interest in maximizing personal bonuses that clearly outweighed concern for other stakeholders, much less the vulnerable members of society. In a culture where the desire for

[25] Dungey, Dwyer, and Flavin, "Vintage and Credit Rating: What Matters in the Abx Data During the Credit Crunch?."

compensation and bonuses coupled with fantasies for greater personal wealth is paramount, the identity of the individual as a member of a community is diminished, and the integrity of that person is tarnished. With the progress of time the willingness to act morally has been gradually extinguished.

Other commentators have opined that even in institutions that have put in place computerized systems requiring employees to regularly receive training on codes of ethical conduct it is reasonably easy for errant staff members to fool the system by taking the tests and giving the correct responses without agreeing to any of the principles being imparted. In other words, compulsory training in ethics does not necessarily produce ethical bank employees.

The case study of the sub-prime crisis and the continuing travails of credit card customers have demonstrated the deception and the deliberate lack of transparency among bankers and other lending institutions. While the lenders that went bankrupt and the senior executives who lost their jobs expressed regret for their misfortunes, there was no remorse on their part for the entrapment of many susceptible borrowers. Several lenders went so far as to accuse the hapless borrowers for bringing about the disaster upon themselves.

Amazingly many of the financial institutions in America and Britain, which had encountered severe monetary difficulties and needed to receive emergency support from their respective central banks, brazenly paid enormous bonuses and termination payments to their CEOs and other senior executives. Even after financial failure these firms claimed that they had contractual obligations to pay huge bonuses to these executives. They were essentially rewarding failure!

But in this morass of greed and disintegration there is evidence of apparent good conduct. In America the firm, JP Morgan Chase Manhattan Bank, whose progenitors include the legendary J. P. Morgan[26] and David Rockelfeller,[27] revealed that it had avoided the excesses of the sub-prime exuberance and thus maintained a healthy balance sheet and was therefore called upon by the government to rescue the investment bank Bear Stearns and the retail bank Washington Mutual. The CEO of JP Morgan Chase also chose to forego his bonus for the year 2008. In Australia the CEO of the largest investment bank, Macquarie Bank, gave up his bonus and went from the highest earner at nearly A$ 29 Million the previous year to A$ 290,000 in 2008.

Several of the banks that were interviewed in Australia and Hong Kong continued to illustrate transparent behaviour though one of them (as earlier described) experienced a problem in its treatment of loans to stockbrokers whereby it had ignored the impact on the customers of the stockbrokers and consequently smudged its reputation in the process. The newly installed Chief Executive of the affected bank[28]was especially upset with this unfortunate situation because he is a strong advocate of maintaining a good reputation. His action to immediately conduct an investigation and publicly announce its findings is highly commendable as a sign of transparency. The CEO also stressed the necessity of fostering cultural change in his organisation in order to infuse ethical values in all personnel.

[26] Noted as an early Wall Street titan.

[27] Well respected for his personal concern for other fellow human beings.

[28] Transcript AU 19.

D. Prognosis for the Future

This thesis has probed into banking attitudes and behaviour in order to gain a better insight into the underlying values. Several deficiencies as well as positive aspects have been identified. The causes of the recent financial crisis and the responses thereto by the banking industry and regulators have been analysed. What prospects does this analysis portend? What values do the banks in the study reveal?

D. 1. Ethical Pluralism

In appraising the results of the empirical research it is manifest that bankers rely on pluralistic ethical stances in the sense that they are driven by varying ethical principles. All of them exhibit utilitarian attitudes in claiming to offer financial opportunities to numerous segments of the population. Many bankers can be portrayed in the context of the rational actor paradigm; they pursue personal gains and corporate profits with vigour, insisting that their endeavours will bring overall economic prosperity. At the same time most institutions proudly announce their reports of corporate social responsibility. As this thesis has shown, the motivation and practice of social responsibility vary among different financial institutions. Several banks assert deontological principles in claiming to advocate good corporate governance and legal compliance. Some institutions speak about the importance of protecting their reputation, which can mean both an opportunistic approach to maintaining market share and a desire to be seen doing good for customers. The espousal of virtue ethics likewise appears in a handful of banks, which genuinely seek to foster a close bond with their respective communities.

The ethical pluralism of banks reveals itself in their corporate declarations and in specific activities. For instance, one Australian bank that claims to care about its good reputation states that it does not lend to marginal, sub-prime clients, which shows that the institution disavows predatory, imprudent lending. However, this likewise means that the same bank may be excluding the economically and socially disadvantaged section of society from banking services. In a similar vein, the bank that previously declared that it would keep its call centres in Australia (because it wanted its employees to be able to relate to local customers) later outsourced those activities to India in order to cut costs. A banker, who said that moral standards should be left in the hands of legislators, complained at the same time that there were too many regulations affecting banks. In other words, there was a reluctance to assert ethical beliefs beyond those prescribed in laws, but there was also an aversion to regulation. Everyone accepts that traders and dealers operate according to a culture of self-interest that is exceedingly susceptible to fraud; therefore all financial institutions put into operation a system of checks and balances, frequent audits, and whistle blowers. This is a scheme based on distrust and the threat of punishment, though more enlightened banks strive to cultivate an environment of transparency that leads to collegial sharing of information and helps avert dishonest behaviour. In their discourse and actions banks reveal a number of ethical principles. Due to this plurality individual bankers adopt diverse ethical responses to situations confronting them, but it is evident that they are fully conscious of morality, even if they have never been exposed to the study of ethics. However, moral awareness has not prevented some financial institutions from committing injustice and wrongful deeds.

D. 2. Glimmer of Hope

Critical observers can better appreciate the significant weight of entrenched ethical values in banks after having witnessed the consequences of ethical failure. Millions of Americans have lost their homes due to irresponsible and unjust lending practices. Myriads of credit cardholders all over the world continue to suffer from high interest rates and fees that they have not fully comprehended and are now unable to escape. Defenceless minority groups and elderly retirees in many nations are still subjected to irresponsible lending techniques. The reluctance of banks to pass on interest rate cuts from central banks in America and Australia is a blatant example of corporate greed. But there is a spark of hope.

One may accept the optimistic perspective that the global financial crisis and recession persisting till 2009 may have modified the cultural values of society. Whereas the leading business schools of top universities in America and the rest of the world were producing graduates who were enthusiastic about careers on Wall Street and other major banks, recession decimated job opportunities in the finance industry and thousands of bankers lost their jobs while many banks failed and needed to secure government support. Several major financial institutions such as Bear Stearns, Merrill Lynch, and Washington Mutual (a large retail bank) had to be absorbed by other banks. Lehman Brothers, a leading Wall Street bank, was forced to declare bankruptcy. Bank of America and Citigroup, two of the largest global banks, had to receive massive capital infusion from the American Treasury in order to survive. Banks all over the world have suffered financial losses and continue to shed staff, so there has been a tendency for people in general to become less trusting of banks and for young people to be less fanatical about banking careers. The prevailing attitude toward business education has begun to veer away from a heavy concentration on finance and banking.

In March 2009 an article in the New York Times questioned the relevance of M.B.A. degrees granted by graduate business schools, especially when the top executives at the helm of some of the most spectacular Wall Street failures have such a degree: the CEOs of Merrill Lynch, Lehman Brothers, and Citigroup.[29] There were reports of regular cheating among 56% of all M.B.A. students, and there were laments that the training was slanted towards maximization of shareholder wealth without due consideration about social impact. Both the cheating and the focus on shareholder value indicated a slant towards unrestrained selfishness. The Times article also referred to Henry Mintzberg of McGill University who disparaged the case study method that was popularised at Harvard, because he argued that students were taught to respond too quickly to case reports without the benefit of reflection on their own life experience. According to Mintzberg, this overemphasis on quick decisions instead of assessing all the facts and the consequences produced the first American president with an M.B.A., George W. Bush, who was blamed for many rash and faulty decisions.[30] However, an Economist report in June 2009 noted that more than 400 graduating students from the Harvard Business School had taken an oath to uphold ethical principles: "serve the greater good, act with the utmost integrity, and guard against decisions and behaviour that advance my own narrow ambitions, but harm the enterprise and the societies it serves."[31] This is certainly a positive development, which could have a ripple effect in education.

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[29] Kelley Holland, "Is It Time to Retrain B-Schools?," *The New York Times*, 14 March 2009, www.nytimes.com (accessed 15 March 2009).
[30] Henry Mintzberg, "Leadership Beyond the Bush Mba," (2004), www.henrymintzberg.com/pdf/leadershipbush.pdf.
[31] "Forswearing Greed," *The Economist*, 4 June 2009.

The keynote speech at the Harvard function was given by Jamie Dimon, the chairman and CEO of JP Morgan Chase, who recounted the accomplishments of Chase during the crisis period. However, the commencement speaker at the Wharton School was Muhammad Yunus, the founder of the micro-finance Grameen Bank and winner of the 2006 Nobel Peace Prize, who spoke of his vision of "social business, whose purpose is to address and solve social problems, not to make money for investors."[32]

> While other experts are banking on gloom and doom, I see the economic downturn as a prime time to shake things up in a positive way that will lead to permanent social change. This is a big crisis, but this is also a big opportunity to redesign and retool, so we don't have to go back to the same normalcy. So in a certain way, the crisis is good; it gives us a good opportunity to redesign for the better.[33]

The community banks and credit unions in Australia have been moving in the right direction of engagement with communities. But all banks should exert more effort to address the financial needs of the underprivileged. The programmes by some banks to encourage corporate social responsibility and to endorse ethical behaviour training are definitely good initial steps, but concrete action must follow. The affirmation by one Australian CEO of the need to foster cultural change in order to breed ethical consciousness is especially encouraging.[34]

There is hope that people will become less enamoured with the chase for money and material goods because of the realisation that these are ephemeral and offer no lasting satisfaction or reward. By August 2009 reports were emerging about the reluctance of people to spend and a propensity to use debit cards instead of credit cards, that is, reliance on available cash rather than borrowing against expected future

[32] Ibid.
[33] Ibid., excerpt of Mr. Yunus' speech.
[34] Transcript, AU 19.

income. The move away from consumerism and dependence on borrowing are positive indicators for individuals.

There is anticipation that ethical values are being cultivated as banks and their staff members commit to engagement with their respective communities because in the process they truly learn practical wisdom. They need to absorb the critical values that have been enunciated, but to become truly virtuous in respect of these values they should not only ask themselves what is the right thing to do but also what is the good thing to do in each situation. The right action would be that prescribed in the ethical code of conduct of their institution whereas the good act would be one they choose based upon reflection on the specific situation and its potential impact on other individuals.

In the entanglement of the lingering financial catastrophe people have seen many examples of ethical failure that have made them realise what justice and goodness truly mean. As economies recover, individuals and banks should be able to apply the lessons of practical wisdom in their lives. The onus on all members of society is to create the conditions to make this happen.

D. 3. Implications for Action

In August 2009 the economic reports in Germany, China, and America started to sound encouraging and announced that the end of recession was in sight. These optimistic developments confirmed that the drastic economic measures employed by the leading central banks in the world had succeeded. Companies and consumers were heartened by the positive news, and there was a general sigh of relief that the crisis would soon be over. The problem with this early euphoria is that people seem to have forgotten the lessons from the crisis.

There have been confirmed accounts in 2009 of many banks and financial institutions returning to the old culture of guaranteed bonuses and generous monetary compensation in order to entice perceived high-performers to join the banks or to retain their loyalty. Although performance rewards are certainly appropriate, excessive pay packages irrespective of performance are definitely questionable and, in most cases, the causes of unrestrained risk-taking and the probable inducements for ethical failure. After all, these enormous bonuses were the fires that ignited the sub-prime lending in America and encouraged dealing fraud in the global banking world. The current revulsion towards extreme compensation for bankers harks back to the medieval condemnation of usury and the distrust of the profit motive. The issue underneath the recent censure of huge bonuses is the lack of justice in apparently disproportionate rewards. How can responsibility, fairness, and transparency in the financial system be assured?

The first implication is that values must be continuously strengthened in banks through appropriate education of all employees and constant affirmation of moral integrity by the leadership. The temptation for individuals and institutions to grow lax and complacent must be combated with resolve. As prosperity returns, most individuals and firms might revert to 'business as usual', which can sadly mean indifference to moral concerns. But this need not be the case.

The second implication is the acknowledgement that banks continue to be rational actors in pursuit of their own narrow self-interests, and therefore conflicts of interest will persist. In this respect it is highly important to encourage further progressive regulation of banking that will permit the continuing development of financial products that enhance the lives of ordinary people while preventing consumer exploitation and corrupt behaviour.

Banks perform a critical role in society, but regulations should be firmly in place in order to ensure that everyone in the community is adequately protected against abuses and failures of the banking system. Innovation by banks must continue to be encouraged so they can contribute to the wealth creation of individuals and companies but ethical values should be instilled in banks, and safeguards must be implanted to guard against unscrupulous behaviour. The discourse and actions of bankers have disclosed their dislike of regulations and their clever manoeuvring to surmount legal obstacles. Influential lobbyists are well paid by banks to attempt to sway the opinion of legislators in favour of the finance industry. In addition, banks employ large teams of highly skilled lawyers to either circumvent, or certify compliance with, the laws. The regulators must remain vigilant and not slip into a passive mode with the false justification that market forces will correct excesses. The failure of markets has been dramatically proven during severe financial crises and countless individuals have suffered as a result. To guarantee justice in society, ethical values should be embedded in banks through leadership and education while enlightened regulation encourages moral restraint.

Appendix A.

INTERVIEW WITH BANK CHIEF EXECUTIVES

(Questions Presented at Interviews)

A. DEPOSITS FROM INDIVIDUAL CLIENTS

1. What is the policy on the maximum daily limit that a client can withdraw from an ATM or transact through a debit card?

2. Please explain your bank's policies and guidelines on money laundering and corrupt practices of clients.

B. CREDIT CARDS

1. How does the bank establish policies on credit limits for credit card customers?

2. Is there a process for early detection of potential financial difficulties among customers?

3. Does the bank have procedures for dealing with customers who are unable to repay?

C. HOUSING LOANS

1. Some countries like Australia have experienced a property bubble that was driven by high demand and speculative fervour. According to independent analysts such as those at the London Economist, much of this housing boom was fuelled by easy credit from banks competing fiercely for a share of the business. Would you care to comment on this?

2. Housing finance is so readily available, that some homebuyers eventually have difficulty meeting their obligations. What is the policy on advising prospective borrowers on prudent limits on the amount of their loans and manageable levels of debt amortisation?

3. Are there provisions to assist customers who default on their obligations?

D. CORPORATE FINANCE

1. In financing acquisitions, expansion, or new projects, do the loan officers discuss the ethical impact with the customer? Do they discuss with corporate or other institutional clients possible eventualities such as worker displacement or obsolescence or possible failure of the contemplated projects? If the potential fallout from such financing could be so large, would your bank be willing to forego the financing

opportunity?

2. Does your bank have policies against companies that cause environmental harm, or participate in corrupt practices, or condone the exploitation of workers, children and women?

E. BANK GROWTH AND EXPANSION

1. Do you favour expansion through mergers and acquisition or organic growth?

2. Do you believe that your bank is better able to serve its customers through growth?

3. Do you believe that employee redundancy is avoidable and desirable?

4. Do you believe that mergers and acquisitions enhance the bank's shareholder value?

F. FOREIGN EXCHANGE AND SECURITIES TRADING

1. Please explain how your bank currently instils integrity and prevents conflicts of interest and fraud in the trading room.

2. Would you have a suggestion on how this could be improved?

G. CODE OF CONDUCT

1. How would you describe the values of your bank?

2. Please describe the process that enabled your bank to affirm these values?

3. How do you ensure that these values are shared throughout the organisation?

4. Do you believe that the Code of Conduct developed by the Bankers Association satisfactorily embodies these values?

H. TRUST RELATIONSHIP BETWEEN FINANCIAL INSTITUTIONS AND REGULATORS

1. What do you see as the key principles of banking regulations?

2. Describe the role of corporate governance in your bank? Does it focus only on compliance?

3. How effective is industry self-regulation?

4. Can you quantify the costs and benefits of government regulation vs. self-regulation?

5. How would you characterise the level of trust on the part of regulators towards the banks?

Appendix B.

QUESTIONNAIRE ON BANK PRACTICES

(Questions Presented at Interviews)

A. **DEPOSITS FROM INDIVIDUAL CLIENTS**

1. Please describe how the bank's marketing strategy for attracting deposits places the customer service ahead of mere profitability and greater volume.

2. Does the bank set standard restrictions for customers on the maximum amount of withdrawal per day for debit card and ATM transactions? Do these consider the amount of available funds that the customers have on deposit?

3. How thoroughly do customer representatives advise potential and existing clients on the options available and the related benefits and costs? Do they give full advice on maximum withdrawals per day and minimum balances that must be maintained?

4. Do bank representatives fully explain the contents of the relevant brochures?

5. Is the compensation of the customer representatives and relevant managers linked to volume and income targets?

B. CREDIT CARDS / PERSONAL LOANS

1. Please describe the marketing strategy for attracting new credit card customers / borrowers.

   What is the profile of the targeted customer?

2. What is the emphasis in the advertising campaign?

3. Please explain how the credit standards filter out irresponsible borrowers.

4. Do bank representatives advise customers on prudent use of their credit cards?

5. Is the compensation scheme for credit card staff and managers linked to performance in this segment?

C. HOUSING LOANS

1. What is the marketing strategy? Are there target classes of customers?

2. How are the loan criteria established? Is additional borrowing permitted on the same security if the property value rises?

3. Do loan officers advise clients on the suitability of loans in relation to their repayment capability?

4. Is the compensation scheme of bank staff in this segment linked to volume and income targets?

D. CORPORATE FINANCE

1. Please comment on the credit policy guidelines in relation to ethical considerations.

2. Are there specific industries designated as unsuitable for financing due to economic, community, environmental, or ethical reasons?

3. Do loan officers advise clients on the suitability of the requested financing in relation to repayment capability?

4. Please comment on the guidelines for the treatment of past due loans.

5. Please comment on the linkage between compensation and performance, in terms of volume and income contribution for the individual loan officers.

E. FOREIGN EXCHANGE AND SECURITIES TRADING

1. How do the bank's internal regulations avoid conflicts of interest and fraud in the trading room?

2. Is there a correlation between the compensation of traders and dealers and their performance in terms of volume and income? Please comment on the ethical implications in this situation.

F. DIRECT INVESTMENTS / PRIVATE EQUITY

1. Does the bank, on its own or through a subsidiary, participate in private equity or direct investment?

2. What are the bank's investment guidelines on industry and project preferences?

3. Please describe the ethical considerations contained in the investment policy.

Appendix C.

INTERVIEW TRANSCRIPTS

(Contained on CD)

AU = Australian Interview
HK = Hong Kong Interview

AU1.doc
AU2.doc
AU3.doc
AU4.doc
AU5.doc
AU6.doc
AU7.doc
AU8.doc
AU9.doc
AU10.doc
AU11.doc
AU12.doc
AU13.doc
AU14.doc
AU15.doc
AU16.doc
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HK1.doc
HK2.doc
HK3.doc
HK4.doc
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HK7.doc
HK8.doc
HK9.doc
HK10.doc

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